ETG

The UK Emissions Trading Group Ltd

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By email

Jos Delbeke
Director-General Climate Action
European Commission Avenue de Beaulieu/ Beaulieulaan, 5
B-1049 Brussels, Belgium.

Dear Jos,

UK Emissions Trading Group (ETG): Response to the public consultation on structural options to strengthen the EU Emissions Trading System

1. The ETG supports the EU Emissions Trading Scheme (EU ETS). The EUA markets are functioning: there is a liquid market with a clear price, the EUA auctions are clearing and the 21% EU ETS GHG reduction target will be achieved in 2020. The ETG also particularly favours the harmonised nature of the EU ETS across the EU.

2. The aim behind the Commission proposals for market reform is to look at how better to align supply and demand in the longer term. The ETG notes that all of the Commission's proposals would require primary legislation via co-decision, and that the 'do nothing' option - letting the market work - must be seriously considered as an alternative to regulatory intervention. Regulatory intervention carries its own issues and consequences including increasing regulatory risk in trading.

3. The ETG would like to thank the Commission for acknowledging that the CMR contains a non-exhaustive list of options for reform of the EU ETS. As mentioned there are indeed options that the Commission has not discussed which do further merit investigation either alone or in combination. Two are mentioned in this paper.

4. The ETG believes that any solution to the Commission's proposed reform of the EU ETS must also include measures to cover the non-traded sector to ensure that the effort sharing agreement is in-line with any revised ambitions for the EU ETS. However, none of the six options consider this balance under the Climate and Energy Package between EU ETS and the Effort Sharing Agreement, or consider the impact of other overlapping policies and measures. The overall aim of the reforms must be to ensure the certainty of the cap - by looking at longer-term milestones beyond Phase 3 to create a demand profile less prone to fluctuation, with consideration of a more dynamic but predictable response to supply. This should also reduce short-term volatility in the system.

5. Since the Phase 3 allocation (and the definition of the cross sectoral correction factor) is not yet completed, specific comments on reform options from the perspective of installations is made more difficult.

6. Any options must also consider progress in international climate change negotiations and by the EU's international competitors. If there is too great an ambition without mitigation and reduction efforts elsewhere in the world it would simply result in a reduction in EU competitiveness, and risk carbon leakage.

7. On the issue of auction backloading, the vast majority of ETG members are against such intervention but there is, however, no overall consensus

8. The EU ETS contains the Article 28 provision for "*Adjustments applicable upon the approval by the Community of an international agreement on climate change*". Sadly, with Kyoto 2 containing fewer signatories than its predecessor, and with difficulties in the international UNFCCC negotiation process, the conditions for the option to amend the Directive in **Option a: Increasing the EU reduction target to 30% in 2020** are not met.

9. If **Option a**: is exercised unilaterally by the EU, there will be issues regarding EU industrial competitiveness based on carbon leakage carbon leakage unless all additional effort is taken by the non-traded sector. It is also unclear if the measure is solely aimed at Phase 3 or whether it is intended to form a permanent and on-going intervention by changing the future trajectory of the EU ETS via future cap setting. 2020 is tomorrow in terms of the capital investment cycle for large installations.

10. **Option b: Retiring a number of allowances in Phase 3.** This is the Commission's option to directly reduce demand by cancelling allowances held by Member States. Unlike other options it can be deployed as a one-time intervention, though still an intervention in the market with issues of how many allowances to be retired and when. As such, it was unfocused as an isolated event that does not address supply and demand issues over the longer term. There is also no indication of the scale of retiring the Commission has in mind.

11. **Option c: Early revision of the annual linear reduction factor,** if applied, would also change the overall trajectory of the scheme without corresponding international action. Like Option A, it is unclear if the linear factor revision is a permanent intervention or a temporary revision designed to reduce surplus. Removing 'surplus' has a very different dynamic compared to advancing the date of no net emissions in the EUETS. As an option longer term it also requires details of the level of reduction effort required of the non-traded sector.

12. **Option d: Extension of the scope of the EU ETS to other sectors.** This is a troubling suggestion in that the proposal requires underrepresenting any additional sector to "*impact the overall ambition level, depending on the level of the cap foreseen for the sectors included*." Such an idea is not new: the ECCP II programme considered the road transport sector and other non CO2 gas sectors and rejected both for inclusion: it has to be fundamentally revamped. The EU ETS had been designed for the direct emission sectors already included and different targets and a new approach to MRV would be needed if different sectors were to be included. In addition the policy instruments such as minimum EU fuel duty rates would need to be amended to balance the cost of carbon, and the successful programme of fuel efficiency targets for new vehicles are rendered obsolete. Finally, the market dynamics would be altered with the inclusion of new sectors where the carbon price at the end-user level would leave the bulk of reductions to be carried out either outside the EU ETS via offsetting or by reducing EU industrial emissions substantially making EU industry outsourcing even more attractive.

13. **<u>Option e: Limit access to international credits.</u>** Under the 'Linking Directive' access to international project credits have always been limited (e.g. nuclear, large hydro, carbon sinks etc.). ETG Members support the use of international offsets in EU ETS because it recognises that reduction of CO2 and other GHG emissions elsewhere is equally valid in environmental terms, and because it facilitates international participation in GHG emissions reduction. Such offsets should be subject to a robust MRV regime and are additional to that which would have otherwise occurred. However, this option has already been partially exercised in the total offsetting already allowed for by some member states, and as the Commission has succeeded in further reducing the scope of emission reductions from projects associated with Kyoto project mechanism credits from industrial gases, and now proposes to limit the use of ERU certain offsets post 2012. Given this declining eligibility of certain project credit use, it appears that the Commission are enacting this option anyway. Thus there is also limited opportunity for use of offsets as a bargaining tool in international negotiations.

14. **<u>Option f: Discretionary price management mechanisms</u>** The ETG believes that markets are best placed to match supply and demand, rather deferring to some central administrative function to intervene in the market to give the 'correct' answer. Even with the strategic reserve option there is the issue of when / when not to use it. Pre-planned trigger points can only make use of current views on future situations.

15. Going beyond the Commission's six preferred options, there are arguments to consider a closer matching of supply and demand. ETG members are aware of the imbalance between the EU ETS cap which is set with a reference to a fixed base of installations and their emissions, and the fact that installations that cease or reduce capacity or fall below the EU ETS Annex I thresholds do not affect the total cap supply but do reduce demand.

16. Thus the ETG suggests looking at the dynamics caused by significant capacity reductions, cessations and partial cessations of installations introduced from Phase 3. This could include a degree of harmonised ex-post adjustment based on the Australian scheme (though with a longer time horizon of five years), or a GDP linked or other inflator - though we acknowledge linking emissions, allocation and GDP changes could give unexpected consequences.

17. Another option to avoid greater auctioning volumes is by permanently retiring a 'contribution from the cap' derived from such installations. Such a design feature is predictable, automatic and covered under existing installation monitoring, reporting and verification rules. Note a 'contribution from the cap' is calculated from an installation's contribution to the overall cap rather than from free allocation; the latter would not adjust the cap for affected installations in electricity generations and production sectors for example that lack free allocation.

18. If there are new EU ETS installations, then the New Entrant Reserve (NER) mechanism for new entrants is designed to accommodate emission growth under the cap. Contribution from the cap allowances could be placed in the NER, and used to balance an economic cycle downturn changing to a cyclic greater demand on the NER by new entrants. At the end of the phase, 'contribution from the cap' allowances that have not been recycled to new entrants would be cancelled.

19. Another variation is that of ex-post adjustment. While this has been previously rejected by the Commission and industry, perhaps this was because such adjustment was assumed to be downwards only. If adjustment were to be linked to the economic situation in the EU it could go up as well as down - though this implies either a level of rationing via a new cross sectoral adjustment factor if the cap is fixed or a flexible cap. While ex-post adjustment can negate the installation benefit of reducing

emissions by new investment partially funded by the sale of future unused allowances, ex-post adjustment could revisit the previous EU ETS installation rationalisation rules to facilitate the closure of unused or inefficient capacity.

20. Finally, the ETG believes that as the EU ETS Directive will need amendment under co-decision in time for Phase 4 to continue to address carbon leakage.[1] The start of Phase 4 also gives the right regulatory timeframe for implementing any structural changes to EU ETS. Such a timeframe allows the market to respond to any changed supply/demand balance via banking.

The ETG welcomes the Commission's consultation, trusts that the above points will be considered in the post consultation analysis and looks forward to participating in the ensuing stakeholder debate to strengthen the EU Emissions Trading System.

Yours sincerely.

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ETG Chair

Cc Mr Daniel Calleja Crespo – Director General DG Enterprise
Mr Peter Zapfel – Head of Policy Coordination, DG Climate Action

[1] EU ETS Article 12.10 *Subject to Article 10b, in 2013 and in each subsequent year up to 2020, installations in sectors or subsectors which are exposed to a significant risk of carbon leakage shall be allocated, pursuant to paragraph 1, allowances free of charge at 100 % of the quantity determined in accordance with the measures referred to in paragraph 1.*