Memo

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Date	21 February 2013
To	European Commission, DG CLIMA
From	Energie-Nederland (registered under number 619995310682-09 in the EU Transparency Register)
Subject	reaction to consultation on Carbon Market Report

Reaction on the Carbon Market Report

Energie-Nederland, the association representing the electricity and gas industry in the Netherlands, welcomes the Carbon Market Report of the European Commission. Where the back-load proposal serves as a first step to restore confidence in the ETS, structural measures are required to strengthen and reposition the ETS as the key instrument to address carbon emissions.

Urgent action needed to keep ETS alive and strengthen its key role
Currently, the ETS is confronted with low carbon prices due to a large surplus of allowances, which has been built up due to various reasons. Unless action is taken, this surplus will continue to accumulate and carbon prices will remain at low levels or may even slip further. This situation strongly complicates investments, which are required in the transition towards a low carbon energy supply. Also, confidence in the future role of ETS as the key instrument for Europe's climate policy is at stake. Therefore, action is urgently needed.

The need to implement measures to strengthen the ETS has become more prominently following the market reaction on the negative advise of the ITRE Committee of the European Parliament on the backload proposal. Without a clear and coherent package of measures, the ETS may be lost altogether. The costs of losing ETS will be very large in our view. First of all, it would send a signal to markets and investors that a coherent European climate policy fails to exist. This may give rise to a fragmented set of national policies across member states with serious implications for completing the internal energy market. Europe runs the risk under such a scenario that investments in the power sector will be paralyzed for a long time or even will be moving away from the decarbonisation path in certain parts of Europe. In the international arena Europe may loose its credibility when the flagship for carbon abatement disappears.

Structural measures are needed in addition to back-loading
The earlier proposed back-loading of allowances will marginally help to support the price level of CO2, since it only shifts the amount of allowances in time. The shift in time could allow for an economic

recovery of Europe, which would help to diminish the excess amount of allowances in the market. However, the surplus is so enormous, that shifting of allowances and hoping for economic recovery will not help in any way to bring carbon prices back on track. Therefore, structural measures to adjust the ETS are the only remedy to restore carbon prices at pre-crisis levels, which will enable future low carbon investments.

Timing is crucial … measures should be taken as soon as possible

In our view, the Carbon Market Report proposal should serve as a signal to the market of the willingness and intent of the Commission to propose a package with structural measures at any time soon. The content of that package should be aimed at eliminating the current surplus to enable a more balanced situation between supply and demand.

The new policy measures should come into effect in the third trading period. Recognising the course of European legal proceedings, we call upon the Commission and European institutions to proceed as quickly as possible. This implies that the Commission seeks to put forward a legislative proposal and tries to complete this process with the other European institutions within its current mandate. We realise that this creates a challenging time frame for the EU policy process. However, we fear that the market will see any delay as a lack of urgency to fix the current detrimental state of the ETS and a lack of support for a continuing climate policy of the EU.

A package of measures is required rather than implementing a single measure

The Carbon Market Report identifies six options to address the current shortcomings of the ETS. The analysis might suggest that these shortcomings can be fixed by implementing a single measure only. In our view, the current state of the ETS with its very low prices is due to such a surplus of allowances that a combination of measures is required to restore prices for both the short and long term. The current surplus amounts to nearly one full year of carbon emissions under the ETS. This provides a substantial depressing factor on carbon prices. The magnitude of the surplus is so large, that taking a single structural measure will not be sufficient to reduce the existing surplus. Unless a combined package is introduced, the depressing impact on the carbon price may well last beyond 2020.

Recommended package

Our analysis indicates that a combination of a permanent set-aside, lowering the cap for 2030 and adjusting the linear reduction rate before 2020 elements is required to restore the balance between supply and demand of allowances. Therefore we call upon the Commission to propose as soon as possible a package to improve the ETS in a structural way with the following measures:

1. Bring the economy-wide CO2 target for 2030 in line with the reduction path towards 2050 (as included in the roadmap for a low-carbon economy and in the long-term goal of the European Council) by at least a reduction of 45%
2. Therefore, adjust the linear reduction rate in ETS to at least 2¼ % as soon as legally and technically possible in the third trading period
3. Transform the back-load proposal into a permanent set-aside in which a substantial amount of the surplus is taken out of the market
4. Widen the ETS by bringing in more sectors from 2020 onwards.

Comments on the six options of the Report

The Carbon Market Report provides six potential structural measures to strengthen the ETS:

a. Increasing the reduction target for 2020 from 20% to 30%
b. Retiring a certain number of phase three allowances permanently
c. Increasing the 1.74% annual reduction rate
d. Bringing more sectors into the ETS
e. Limiting access to international credits
f. Introducing discretionary price management mechanisms.

In our view, options (a), (b) and (c) are strongly linked. Increasing the reduction target for 2020 is an option, which has as disadvantage that it does not provide a clear long-term signal to investors in the power sector regarding the reduction path beyond 2020. The current annual reduction rate in ETS of 1,74% clearly falls short in reaching the long-term objective of the EU for 2050. Therefore, reducing the target for 2020 without adjusting the annual reduction rate in ETS does not provide a clear long-term signal for investments. Therefore, we strongly prefer to set an ambitious target for 2030 (which is in line with the reduction path towards 2050) and increase the annual reduction factor of 1,74% accordingly. Our preference is that the revision of the annual reduction rate takes places as soon as possible and takes effect before 2020. It would then be in the order of 2.3% per year, while a later revision would require a steeper linear factor to reach the same goal in 2030.

The combination of a stronger goal in 2030 and an increased reduction factor pays out in particular beyond 2020, when addressing the current oversupply of allowances. In the short term, however, it helps very little to rebalance supply and demand of allowances. In order to support a more viable carbon price, therefore, short-term action is required as well and retiring a number of allowances permanently from the market is needed to restore the balance between supply and demand. Previously, we have called for a retirement of 1.4 billion allowances in reaction to the consultation on the back-load proposal. We note, that the Commission has now set the back-load volume at 900 million. This would be the minimum volume to retire permanently.

We see to option to bring in more sectors in the ETS (d) as a viable way forward to strengthen the ETS. However, adding additional sectors requires careful design and selection. Therefore, widening the ETS is in our view an option which best can take place beyond 2020. A condition to add additional sectors successfully is that the ETS cap is set in a careful way to create scarcity and avoid any overallocation. Widening the ETS should result in creating a real additional demand for CO2 reduction.

Regarding any limitations the use of international credits (e), we advise to consider this option in the light of the outcomes of the UNFCCC/Durban Platform in 2015.

We agree with the Commission that price management (option f) “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.” In our view, ETS is an instrument based to manage the volume of carbon, in which prices are formed in the market based on a balance between supply and demand. Mechanisms to manage the ETS cap, which help to smooth carbon volumes over time, can be helpful to avoid mismatches between supply and demand and thereby support the formation of a meaningful price signal. Further thinking on such mechanisms is welcome.

Need for better policy coherence

In addition, a better coordination is required Europe's policies for renewables and energy efficiency aiming at better integration of the ETS within those policy areas. This holds in particular for the road beyond 2020. Several policy processes are now under way in different parts of the EU institutions, working on different and non-aligned timetables. We call for a single, coherent and finite process of EU decisions, which links together agreement on 2030 targets, steps for the ETS, the future of renewables and energy efficiency beyond 2020, and the internal energy market. This process should be substantially completed during the current Commission mandate.