

# Fixing the EU ETS

## Enel response to the public consultation on review of the auction time profile for the EU Emission Trading System

October 15, 2012



To restore the ETS as the key instrument of the EU climate policy, on July 25<sup>th</sup> the European Commission published a "package of measures" including:

- **A draft proposal to reschedule the auction time profile of Phase 3** in order to restore scarcity in the short-term by postponing the sale of part of auction volumes from the beginning of Phase 3 to the end (back-loading);
- **an amendment to the ETS Directive** to provide clarity on the EC legitimacy in changing the auctions timetable within a trading Phase;
- **a staff working document** providing analytical information on the functioning of the EU ETS.

The EC launched a **public consultation on review of the auction profile for the EU Emission Trading System** to collect inputs and views from stakeholders. As the second-largest European listed utility by installed capacity, and one of the largest compliance player under the EU ETS, Enel Group welcomes the consultation and is willing to give its contribution to the discussion on how to best restore the effectiveness of the EU ETS, both on the short and long-term.

This response aims at providing Enel Group point of view on the current status of the carbon market and needed reforms, comments on the package of proposals released by the European Commission and specific recommendations on the back-loading proposal.

### Key messages

1. Reaffirming a strong support to the ETS as the most cost-efficient instrument to achieve climate targets, Enel Group calls for a structural reform of the scheme aimed at strengthening its role in European climate-energy policies.
2. A short-term action is required to restore trust in the market and unlock investments needed for the transition to a low-carbon economy and for the achievement of long-term objectives.
3. The back-loading option prospected by the EC is a suitable short-term solution if conceived as the first building block of a wider structural revision of the ETS scheme. The formal communication of any reform option should be coherent with such wider perspective.
4. This short term fix will be a worthwhile measure if designed and implemented in an effective way: volumes in the range between 1.0 and 1.2 billion allowances should be withdrawn from auctions sales scheduled in 2013 and 2014 to be re-injected into the market in the three-year period 2018-2020



## **1. The huge oversupply requires structural reforms**

1. The European Union Emission Trading System is under pressure due to the economic recession which is challenging the effectiveness and the credibility of the cap-and-trade approach.
2. The economic downturn is affecting market balance by reducing energy demand and industrial production. As a result, the path of emissions has significantly deviated from the initial baseline scenario, with a reduction larger than the one expected to be triggered by the ETS scheme.
3. At international level, current targets are not aligned to long-term objectives and do not support expectations for additional demand of emission reductions in the short term.
4. Current market unbalance has been also exacerbated by the overlap of complementary policy instruments (i.e. faster than expected deployment of renewables and energy efficiency measures).
5. These factors combined resulted in a huge oversupply: including the carry-over of unused Phase 2 allowances and international offsets, the market is expected to be long of around 2 billion allowances in 2013 and it is not expected to rebalance before 2020. While contingent, these factors highlighted the rigidity of the scheme to adapt to wide deviations in the economic cycles.
6. The market is functioning properly, since the carbon price level reflects market fundamentals. However, large market unbalances make price discovery more challenging, discouraging short-term emission reduction actions (e.g. fuel switching) and threatening long-term investments in low-carbon technologies.
7. The current weak price signal is fostering a debate among political authorities and market operators over the effectiveness of the EU ETS in driving the transition toward a low carbon economy.
8. Enel Group believes the EU ETS is the most effective instrument to reduce emissions at the lowest cost and calls for long-term structural reforms which require:
  - Clarity on long-term goals that the EU wants to pursue and alignment of targets to those goals with the adoption of firm intermediate milestones;
  - introduction of flexibility in the supply side to adapt to short-term contingencies under clearly pre-defined rules.
9. Such measures could deliver the expectations of a greater demand for emissions reductions in the long-term which are now missing, and provide the right signals to plan new investments in low-carbon technologies. More ambitious targets post-2020 should also allow for an increased use of flexible mechanisms to help mitigate compliance costs for operators.

10. In addition, a major alignment of climate-energy policies defined at EU level will be required to avoid overlapping effects and to guarantee a higher level of harmonization among different policy instruments implemented at EU and national level.
11. As structural adjustments will likely require at least 2-3 years to be implemented, a quick intervention to mitigate market unbalance in the short-term is needed to restore confidence in the scheme, provide time for undergoing an in-depth review of the scheme, and to mitigate the risk of the ETS being sidelined by alternative measures.
12. No immediate action would increase the likelihood of alternative more expensive measures being implemented, such as carbon taxes, and that could lead to the collapse of the ETS scheme.

## **2. EC package of proposals**

1. The European Commission proposed a short-term fix through a revision of the auction time profile in Phase 3 (back-loading), but postponed the debate on more structural reforms to the next months without yet providing any direction on the upcoming discussion. While back-loading can address market unbalance on the short-term providing time for discussion on long-term options, this 2-step approach risks to compromise the coherence of the action.
2. The package proposed by the Commission includes also an amendment to the ETS Directive clarifying Commission's legitimacy in changing the auctions timetable. While the amendment proposal would provide additional legal certainty to the process, we feel that the Commission already has the power to act in such way as it successfully did with early auctions.
3. Yet, the current wording seems to be too vague in defining conditions ("where appropriate") and objectives for intervention ("to ensure an orderly functioning of the market"). The text of the amendment should be further detailed to avoid the undesirable effect of increasing uncertainty among market participants, rather than reducing it.

## **3. The case for a "quick fix": the back-loading proposal**

1. Enel Group welcomes the back-loading option prospected by the European Commission as a first building block of a wider structural revision of the scheme.
2. While the Commission estimates at around 2 billion allowances the total market oversupply by the end of 2013, the actual excess inventory is lower because part of those allowances are needed by compliance operators for hedging their exposure to



carbon prices. Accordingly, the back-loading option should entail adequate volumes, enough to give relief to the market, but without tapping into unavailable stocks.

3. Enel Group recommends a volume for back-loading in the range between 1.0 and 1.2 billion allowances as a suitable amount to reduce most of the surplus accumulated throughout the Phase 2 of the ETS.
4. The appropriate timing for the back-loading, coherently with the time needed to implement structural reforms, should be withdrawing volumes from auctions sales scheduled in 2013 and 2014 and re-injecting those allowances into the market in the three-year period 2018-2020. Such action would give relief to market and would provide time to define how to deal with back-loaded volumes in light of the expected long-term decisions on the ETS, which might include a permanent removal of back-loaded volumes.
5. While the marginal cost of abatement for Phase 3 would remain the same due to the unchanged cap, a back-load of allowances will likely produce a positive impact on short-term prices by reducing excess market liquidity, and it would be further reinforced if communicated jointly with a coherent commitment on long-term structural adjustments to the ETS.

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*Enel generates 291.2 TWh/yr of electric power using a balanced mix of energy resources. The generation plants have a total capacity of more than 97 GW, with over a third provided by renewable sources of energy; use of the latter is increasing constantly, especially in North, Central and South America.*

*The Group distributes energy by 1.8 million km of power transmission lines. Moreover, Enel sells electric power to 56.8 million customers and gas to 4.5 million end users, including residential and business customers.*