Climate Market and Investment Associations Transparency Register ID Number - 66155959707-88

CMIA welcomes the European Commission's draft amendment to the EU ETS regulation on auctioning emission allowances. It fully supports the Commission's argument that existing regulation against the backdrop of an unprecedented economic and financial crisis has created an ill-balanced supply pattern of emission permits which will carry on into 2013 and Phase III and which should be addressed. CMIA highlights that the EU ETS should also be reformed in order to address a structural inconsistency between the supply of emission permits and the reduction target it is aiming to achieve. Action is required to tackle the flaws in the original design of the ETS, which have since been seriously exposed by the recession.

The current imbalance in the EU ETS's supply pattern has had a profoundly negative impact on the low carbon investment signal the EU ETS is sending and it will continue to do so unless the supply imbalance is addressed. Moreover, the continuing oversupply has potentially severe consequences for both the development of the low-carbon economy and the credibility of the ETS and the wider carbon market as effective policy instruments.

CMIA supports intervention by policy-makers at this time because of the serious and exceptional prevailing economic circumstances. We believe that this intervention has to be meaningful and decisive, because there would be no point in wasting precious political capital on something that is ill-considered and does not achieve the intended outcome.

Against this background, we support the overall thrust of the Commission's proposal to reduce the auctioned volume in the first years of Phase III. Our detailed recommendations below are intended to strengthen the proposal, so that the intervention is made more effective and can have more of a long-lasting positive effect on the functioning of the ETS. However, as explained in the last sections of this document, we believe that the EU ETS also suffers a structural flaw (which now makes it incompatible with Europe's 2020 emissions reduction target), and we propose a mechanism to address it. This mechanism requires that some EUAs are withdrawn permanently instead of temporarily.

Addressing imbalance in the auction time profile

CMIA recommendation:

- 1.23 billion reduction in EUA supply in the first two years of Phase III
- With the exception of delayed NER300 volumes no auctioning in 2013

CMIA's analysis is that the proposed change in auction profile only partly addresses the imbalance problem raised, by proposing to displace too few EUAs, too slowly, from the beginning to the end of the 2013-2020 period.

Existing regulation allows installations to use more CERs/ERUs per year in Phase II than in Phase III and also allows into the market by 2013 EUAs from NER300 and early auctioning which should be gradually

made available over Phase III. In total, existing regulation is allowing European installations to use **1.23 billion** more permits in the early years, than a linearly declining cap + offset limit would have implied[1].

By proposing to reduce the EUA supply over the years 2013-2015, the Commission's proposal would only finish addressing the supply imbalance in late 2015, whereas to drive positive investment signals this problem should be solved sooner than this, indeed as soon as possible.

Therefore CMIA urges the Commission to propose an auctioning schedule that addresses the issue it has rightly raised as soon as is feasible:

Change in auction time profile	2013	2014	2015	…
Existing auction profile	1056	1044	1092	…
CMIA proposed change	-1056	-170	0	…
Resulting CMIA proposed profile	0	874	1092	…

A structural flaw: EUA supply is not in line with Europe's emission target

Moreover, CMIA believes that the EU ETS is not only affected by an auction time profile problem, but also by a structural problem, allowing for the accumulation of excess supply which undermines its core objectives.

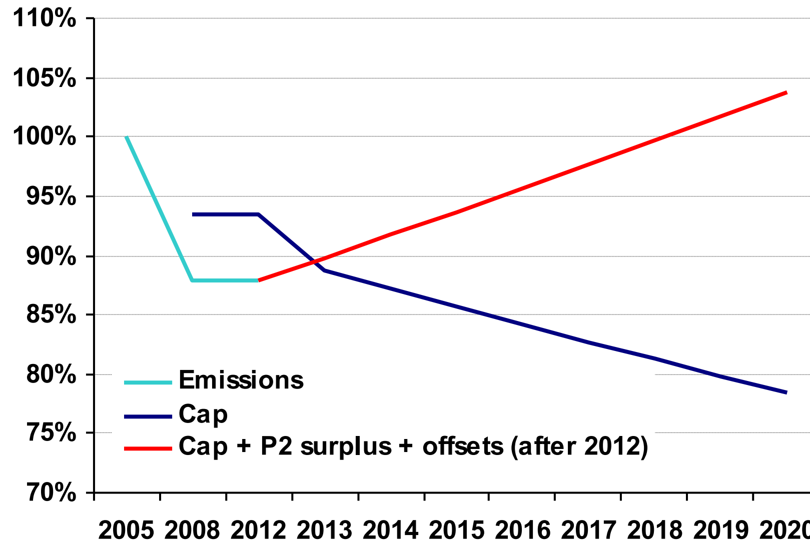
The EU ETS Directive[2] stipulates that the decreasing cap on the quantity of allowances should "ensure that the emissions trading system delivers gradual and predictable reductions of emissions over time".

In addition, the EU has committed both internally and internationally, to reduce its emissions by 20% under 1990 level by 2020. Member States unanimously restated this year that the EU ETS is the cornerstone of European Union climate policies.

CMIA believes that the excessive supply of emission permits in the EU ETS is incompatible with these commitments.

According to recent estimates[3], by 2012 the EU ETS will have accumulated 1.6bn surplus EUAs and CERs/ERUs. If used gradually over the period, the surplus Phase II emission permits and CER use allowance may allow emissions to rise by 18% compared to Phase II, and by 4% compared to 2005.

[1] Averaging out the 1.7bn supplementarity limit over Phases II and III, to 131m per year, would amount to 654m CER/ERU over Phase 2 instead of 1460m. This means there is an excess of 806m supplementarity limit in Phase II. NER300 and early auction represent 420m extra EUAs, so in total the excess is 806m + 420m = 1.226bn permits useable in the early years of the scheme compared to the following years.
[2] Directive 2009/29/EC of 23 April 2009 amending Directive 2003/87/EC
[3] Barclays Capital, Quaterly Carbon Standard, 22 June 2012, p. 29



Source: CMIA

This suggests that the accumulated surplus will likely undermine the overarching objective of the EU ETS to reduce emissions by 2020. Moreover, the growing emission pathway allowed by the scheme may deter emission reduction investments, potentially making it harder for companies to comply with subsequent constraints. As the system allows emissions to grow in Phase III and hence encourage investment away from low carbon technologies, it will have the adverse consequence of making it harder for companies to meet a 30% target in 2030 for example, than if it ensures the 21% cap is met in 2020. The accumulated surplus will then likely undermine the other fundamental principle of emissions trading, to reduce emissions at minimum cost.

CMIA is also concerned that, in the absence of an EU ETS capable of driving emission reductions, the European Union and its Member States may need to implement separate policies aiming to meet their objectives at a higher cost than through an effective carbon market: the UK Government's proposed carbon floor price, which is one such example, could seriously damage the EU single market by introducing competitive distortions between Member States.

Supply control mechanism

CMIA believes that this problem could be solved by systematically removing from the market a number of surplus permits using a transparent mechanism. We are aware that the following mechanism could only be implemented through a revision of the EU ETS Directive that goes beyond the scope of the proposed regulation amendment on backloading emission allowances.

CMIA proposes that, every year, if a certain number of surplus permits have not been used after a period of three years, an equal number of permits should be removed permanently from later supply.

We refer by surplus permits to the difference, if positive, between the cap + imported CER/ERU, and verified emissions. This mechanism would ensure that emissions remain below their limit (cap + offset allowance), on average, for any consecutive 3 years. Such a system would maintain the quantity of EUAs available at a level which ensures that the ongoing EU ETS emissions reduction pathway is duly met.

For the avoidance of doubt, we do not support reducing any agreed free allocation, nor cancelling privately held EUAs but only auctioned volumes. In this way, any carried-over surplus allowances would still be valid for later years and gain value, so that the system would encourage early reductions far more than it currently does.

The table below illustrates the number of EUAs to be removed from auctioned volumes each year using the above mechanism, in an emission scenario given by a market analyst.

	2008	2009	2010	2011	2012F	2013F	2014F	2015F
Cap	2003	2052	2079	2099	2334	2256	2218	2181
CERs/ERUs usage	80	80	135	250	400	150	175	200
Cap + offset usage	2083	2132	2214	2349	2734	2406	2393	2381
Emissions	2119	1882	1937	1893	2117	2126	2146	2156
Surplus (yearly)	**-36**	**250**	**277**	**456**	**617**	**280**	**247**	**225**
Cumulative surplus	-36	214	491	947	1564	1844	2091	2316
Max surplus allowed (3y)	**-36**	**214**	**491**	**947**	**1350**	**1353**	**1144**	**752**
To remove from auction permanently	**-**	**-**	**-**	**-**	**214**	**277**	**456**	**617**

Source: CMIA, Barclays Capital (22 June 2012)

Such a mechanism should be applied regardless of parallel legislation or changes in EU emission reduction objectives, as it only aims for the scheme's existing objectives to be met. It would provide long-term confidence that the EU ETS remains the cornerstone of European climate policies and would reduce calls for intermediate measures. It is only through this kind of reform, coupled with the pursuit of ambitious emissions reduction goals that we believe confidence can be fully restored in the market as an environmental tool for now and into the future.

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About CMIA:
The Climate Markets & Investment Association (CMIA) is an international trade association representing over 60 companies that finance, invest in, and provide enabling support to activities that reduce emissions. CMIA's membership accounts for an estimated 75 per cent of the global mitigation market, valued at USD 130 billion in 2009. Solely representing organizations that provide services to and invest in the environmental sector, membership does not include any entities with compliance obligations under cap-and-trade schemes. This results in a unique advocacy platform with emphasis on the environmental integrity of market mechanisms and climate change policies.

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