

# EFET position paper EU ETS Review 22 June 2007 – Final Draft

## **Introduction**

EFET, with more than 80 member companies, operating in 21 countries, represents the most active traders under EU ETS. EFET is a strong supporter of trading mechanisms as the most efficient way to curb GHG emissions.

Having over two years of experience by now with the current trading system, EFET is convinced that with EU ETS we have a solid basis that -with improvements to be effected- will develop into a strong and effective tool, not only for Europe, but also beyond. Now that the Review Process has taken off, EFET is willing to help the European Commission in improving the EU ETS.

## **Key principles**

EFET is especially concerned with the proper functioning of the emissions trading system and market. A number of key principles have to be met to ensure this:

- Liquidity in terms of traded volume and active traders
- Level playing field for participants
- Clarity on regulatory aspects
- Clarity on factors that drive supply and demand
- Trustworthiness in reported emissions

In order to achieve an optimal functioning of the emissions market, the “rules of the game” have to be set in such a way that these key principles are met. Timeliness of regulation, clarity on key determinants of the market and harmonization where appropriate are key success factors to the functioning of the EU ETS. In addition, proper defined and functioning processes and supporting systems are needed.

## **Recommendations**

Knowing that many parties are participating in, and will comment on, the ETS Review process, EFET wishes to focus on the aspects that are considered as most important from our trader’s point of view.

### **1. Expansion of the EU ETS**

Aiming for a global scheme in future, JI/CDM is currently the only way to link (indirectly) existing and emerging trading schemes. Restrictions on the use of JI/CDM within the EU ETS and future trading schemes should be removed, as these will discourage participation in these mechanisms and effectively lower the efficiency of the trading scheme. The JI and CDM mechanism already provides for sufficient scrutiny for the registration of JI and CDM projects. The role of Host Countries, the CDM Executive Board, the JI Supervisory Committee and the Linking Directive are important elements in providing credibility to carbon credits.

Expansion of the EU ETS with more sectors and gases should be a part of the revised EU ETS Directive, under the following conditions:

- Accurate monitoring, reporting and verification of covered emissions can be assured;
- Included activities incorporate cost-effective opportunities to reduce emissions;
- Administrative costs associated with inclusion of additional sectors and gases are proportionate;
- Inclusion of additional sectors and gases should be done EU-wide.

Given these preconditions, activities and gases that appear especially suitable for inclusion in phase III of the EU ETS are:

- GHG from the production of ammonia, fertilisers and petrochemicals;

- N<sub>2</sub>O from adipic and nitric acid plants;
- Methane from active coal mines;
- CO<sub>2</sub> and PFCs from aluminium production.

To further broaden the scope of the EU ETS, thus improving its cost effectiveness, domestic offset projects should become an integral part of the EU ETS. Using additionality, certainty and cost effectiveness as criteria, domestic projects could be attractive particularly in the fields of energy efficiency, landfill gas, agriculture and forestry. For the trustworthiness of CDM and JI credits in future it is of great importance that the EU will declare recognition of these credits also after 2012, with or without prolongation of the Kyoto protocol.

## 2. Harmonised allocation

Although EFET does not advocate a specific allocation method, we support the development of an EU-wide allocation approach to enhance market transparency, predictability and to avoid unfair competition between installations in different Member States caused by differences in national approaches. EFET therefore advocates setting an EU wide cap. Furthermore, allocation methods should be harmonised by bringing it to the EU-level, most preferably by a single EU-wide allocation, or otherwise by setting EU-wide allocation rules and formulas for Member States to be followed and leaving a minimum of interpretation space. A sector approach could form part hereof.

## 3. Predictability

It lies within the interest of traders to make the emissions trading scheme as predictable and transparent as possible. This will help to assess the amount of EU allowances issued and still to be issued against an estimate of the expected emissions. On that base the trader can estimate the amount of project mechanisms entering the EU ETS as well as the amount of domestic reductions. In so doing the trader will arrive at an own best-guess of the appropriate price for each compliance year and base his trading strategy thereupon. In order for this analysis to be carried out, longer periods of consistent allocation are necessary. For the next phase, EFET suggests a period of eight years (2023-2020), having a parallel planning with the EU 2020 targets.

However there are downsides to a stable and fixed allocation scheme for five or even ten years. As we have seen in the first trading period, allocations can be based on the wrong assumptions, both on national and installation level.

An interest in amending allocation mistakes prevails among traders. This objective is naturally opposed to having a fixed allocation scheme. Therefore a compromise in form of a rolling allocation scheme could provide the answer. The idea is, to keep the general allocation methods fixed for a certain timeframe. In order to increase predictability one could choose to raise the duration of a trading period of for example 10 years. Every 10 years there would be a general evaluation of the EU ETS, similar to the current process involving Member States, and major parameters such as the rate of auctioning or benchmarks could be set.

After one year has passed, the EU-wide cap will be set for the year in ten years time whereas all preceding years will be kept fixed. This should be a relatively simple yearly update of allocation plans within the applicable 10 years' framework regulations. This will be a centralized EU-driven adjustment without MS-involvement to reduce the administrative burden.

## 4. Banking and borrowing

The aspects of banking and borrowing have been controversially discussed. Some argue that banking and borrowing of EUAs is not necessary at all, that CERs and ERUs provide sufficiently for flexibility and that EU internal abatement would be promoted more strongly because abatement would reduce the risk from now even more volatile markets. Others argue that B&B within a trading period allows SME a high degree of flexibility without having to go into the more sophisticated primary market for CERs/ERUs. Some say that time-stamping each vintage of EUA with a clearly defined time span of validity could be seen as a compromise without distorting markets. A clear cut between every trading

period would provide for a well defined balancing period where physical emission-reduction targets can be reached spot on.

An agreement could be found on the fact that banking should be allowed, and borrowing should not be allowed from one trading period to the other, under the precondition that this is well harmonised within the EU.

#### 5. New entrants and closures

Rules on new entrants, transfers and closures should be clear and unambiguous, to provide for more transparency in the market. Rules should be harmonised EU-wide and set in a way that makes it feasible to execute and maintain them. Closure rules need to be consistent with rules of new entrants. If new entrant reserves are still applicable post 2012, there should be clarity and uniformity about what happens to new entrant reserves that are not depleted, as unexpected cancellation or dumping of these reserves will distort the market.

#### 6. Monitoring, reporting and verification

In terms of the practice of monitoring, reporting and verification, there are currently differences between member states that have the potential of disrupting the market. A loss of credibility of reported and verified emissions has a detrimental effect on the market.

Although the MRV guidelines are set at an EU level, Member States have had considerable freedom in transposing these guidelines into national legislation. A comprehensive comparison of all national regulations on MRV for the EU ETS is necessary. Differences in these regulations, resulting in a distortion of the level playing field, need to be corrected. Accreditation of verifiers differs widely among Member States. There is an urgent need for a more harmonised approach, preferably a centralized accreditation system.

#### 7. Auctioning

There's unlikely to be a consensus among scheme participants on how much should be auctioned and the sectors and installations that will be required to buy allowances rather than receive a free allocation. As this also counts for EFET, EFET will not recommend on the *desirability* of auctioning. Nevertheless, given the fact that the auctioning share in many opinions is expected to increase from 2012, there are several criteria to guide this decision. These criteria have been summarised in the annex to this paper.

## Annex to EFET Position paper ETS Review: Auctioning criteria

The question of how to approach to auctioning of allowances can be broken down into separate questions of why, what, who, when and how.

### **Why auctioning?**

Auctioning allowances is often perceived a fair, non-discriminatory and transparent means for allocating allowances. Although Governments have to distribute 95% of Phase 1 allowances and 90% of Phase 2 allowances for free, they have the option of selling the remainder and from 2013 it may be possible for them to be selling a significantly greater share of allowances. Although Governments are free to sell allowances directly or indirectly via a market intermediary or broker, it is important that they demonstrate that the method of sale is both fair non-discriminatory and transparent. Other than for relatively small one-off volumes, where direct sales might be preferable, auctions are generally accepted as the most convenient and cost-effective means of disposal to meet the requirements of fairness, transparency and non-discrimination.

### **What should be auctioned?**

Unfortunately the question that most emitters are interested in turns out to be the most controversial. There's unlikely to be a consensus among scheme participants on how much should be auctioned and the sectors and installations that will be required to buy allowances rather than receive a free allocation. Nevertheless, there may be several criteria that guide this decision, ie:

- The need to mitigate the impact on the international competitiveness of different sectors., eg, greater volumes may be auctioned in the context of a global trading scheme than if the EU continues to go it alone; and
- The need for all sectors to face and respond to the price of allowances and to recognise the opportunity cost of emissions could lead to a desire to ensure that all participants are "a little bit short" so that they have to engage in the market at least at some level. (This can be contrasted with the Phase 1 experience where a "virtual shortage" resulted, at least in part, from the failure of some of the long players to come to market with their surplus allowances.)

Given the presence of an active and liquid secondary market in allowances, we are less convinced by potential arguments for auctioning volumes on the grounds that it helps in the process of price discovery.

### **When should allowances be auctioned?**

In terms of when auctions should take place, we would advocate two basic principles:

- **Little and often:** Allowance auctions should minimise disruption to the secondary market in allowances. Wherever possible they should become a routine and unremarkable part of the market, rather than major events for the disposal of significant volumes. To this extent volumes should be kept well within the volumes that the market can readily absorb on a daily basis
- **Sooner rather than later.** Governments should prevent the creation of "virtual" shortages by ensuring that the underlying supply of allowances in "circulation" at any one point in time is sufficient. In Phase 1 an imbalance between the forward hedging demand of utilities and the ex post disposal of surplus allowances from industrials led to prices rising despite the underlying surplus in the scheme as a whole. These timing effects on prices should be avoided by ensuring that auctioned volumes are front-loaded rather than kept off the market until the end of the Phases.

Although on this latter point, the counter argument is that allowance releases should take place close to compliance deadlines to minimise the cash-flow impact of the purchases and - when added to the scope for installations to "borrow" from future allocations - it would therefore be better for auctions to take place in later years of the Phases. This is based on

a misconception about the cash-flow impacts since the price paid by purchasers in earlier auctions will be lower than the price paid in later auctions to reflect the financial cost of buying earlier and selling later (ie, the “cost of carry” for the relevant stock of allowances).

#### **Who should auction the allowances?**

While individual Member State Governments ultimately remain responsible for determining the volumes for sale – subject to Commission approval – there has been some discussion of a coordinated common auction for all Member States. It is EFET’s view that this would be premature and potentially disruptive at this stage, but that this remains an interesting option to explore further in future. The reason essentially is linked to the previous discussion on timing: the need for Member States to discuss, agree and action a common set of auction rules and procedures would in itself be likely to:

- extend the auctions well into the middle of Phase 2, thereby “backloading” the allocations; and
- could lead to fewer, discrete and larger allocations rather than a diverse range of dates and smaller volumes that would minimise the potential disruption to the market.

The process in itself would also inject a degree of unwelcome uncertainty on the auction timings and volumes. While these issues can no doubt be solved with a considered discussion in time for the Phase 3 allocations, the potential downsides should rule this out for Phase 2. We would, however, note that this does not nevertheless preclude the sharing of the underlying allocation programmes and algorithms between Governments (which is likely to represent the bulk of any savings from coordination in any case).

#### **How should allowances be auctioned?**

There is a huge wealth of economic theory on the auctioning of scarce resources and the optimal design of auctions which should be considered in the context of the design of auctions for Phase 2, 3 and beyond. There are also a wide range of choices among different methods, eg, ascending/descending clock auctions, multiple rounds, sealed-bids etc and the different methods for setting prices paid, eg, pay-as-bid, first-price, second-price, opportunity cost (as in a Vickrey auction) etc. These design differences can yield very different results in different markets depending on the scope for market power, ability to value the product concerned, status of the auction (eg, a one-off sale for all time or a regular allocation etc). However, unlike other areas where auctions are prevalent (eg, spectrum auctions, 3G rights, airport slots) the emissions market has several characteristics that suggest that there is likely to be very little practical difference between the method of auction in terms of the prices paid, ie:

- with circa 2 billion allowances in circulation the market is very large and even the largest players account for a very small proportion of the total allocations which significantly reduces the scope for one or two players to acquire or exercise market power;
- there are virtually no significant barriers to entry into the market and there is a huge range of potential market participants from industry, utilities, financial institutions, funds, etc
- auctioning only covers a proportion of the allowance allocations and hence has a diluted impact on the wider supply and demand (although this will change as the proportion of auctions increase)
- the right being sold is a perfectly fungible, storable tradable commodity (unlike an airport slot or a radio frequency) and there is an active, liquid secondary market which provides a ready benchmark for the value of the allowances being sold (which in turn increases potential participation and reduces the scope for market power further).

In our view, there is therefore likely to be little, if any, difference in the price and volumes delivered irrespective of the detailed design of the auction. At the same time, many designs could in themselves raise barriers to the participation of smaller players. This leads us to recommend that the approach taken be as simple as possible, which is generally a single-round sealed-bid, second price auction.

In terms of other aspects of auction design:

- The rules and platforms used should be straightforward, simple and accessible;
- It is very important that the results of the auction are known as soon as possible after the bid deadline. Requiring bids to be made well in advance and/or revealing the results only days after the auction cause disconnects between the clearing price in the auction and the current market price. This can effectively grant either Governments or participants “free options” to either cancel the sale or purchase in the light of market movements. In turn this can lead to complex rules to prevent participants pulling out and/or bids which are lower than the underlying value of the allowances
- The results should be firm and the scope to default on an accepted bid should be minimised through the provision of sufficient collateral or guaranteed credits lines in advance of the auction.
- The auctioneer may need to pre-qualify bidders both to manage potential defaults, but also to confirm the identity of the bidders (eg, to comply with anti-money laundering legislation).
- We see no real need for reserve prices given the level of competition in the allowances market. However, if these become politically expedient (to provide reassurance that allowances will not be sold well below the market), the level, purpose and/or means for determination of the reserve prices should be communicated to bidders well in advance. Reserve prices should be designed so as to minimise the potential uncertainty on whether or not the auction has been included and, hence, inter alia, should consider the potential for “natural” movements in market prices between the point at which the reserve price is set and the bid deadline.
- In the event that reserve prices are considered as a means of managing the total supply of allowances and/or establishing a floor price (such that if the market appears to be in surplus, allowances will be cancelled rather than auctioned), it is essential that this is communicated to participants well in advance of each Phase at the time that the allowance allocations are determined. While the market can readily price in such contingences if they are signalled well in advance, any change in the allowance supply on this scale during the course of a period would generate damaging uncertainty, winners and losers and erode confidence in the market.