# Cap setting (and allocation)

## European Carbon Investors and Services

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# Signalling and investment

- Emissions trading is a new kind of market: it is primarily policy-driven. But business does not like or understand policy risk.
- While business does not need complete certainty, it does need confidence in the predictability of policy.
- Different investors have different risk appetites: hedge funds, private equity, corporates, pension funds etc. Some actors will move earlier than others but climate change policy needs to deliver scale. Policy makers should send signal that a broad range of actors can understand.
- When Kyoto was signed, hardly any investors took notice.
- How do you close the gap between political signalling (targets) and investment?
  - Credibility – who is sending the political signal?
  - Consistency – are political signals reflected in policy?
  - Visibility – are the policy signals long enough to be relevant to investment cycles?
  - Transparency – is market information abundant and managed well?
  - Simplicity - are the rules of the game clear?

# Predictability

- Every effort should be made to reduce political/policy risk
- Predictability means 'depoliticisation'
- Too much political/policy risk exists in the current system, including:
  - EU level sectoral burden sharing
  - National burden sharing
  - Sub-national sectoral burden sharing
  - Installation level allocation
- The national allocation process provides an additional and unnecessary layer of policy uncertainty and should be removed
- The Commission should be applauded for applying a formula in its Phase 2 decisions – if only it had been published before Member States did their NAPs!
- A **formulaic EU-wide cap** provides the greatest predictability
- This should be supported by an **EU-wide system of auctioning and benchmarking**
- The cap should be set out to 2020, with additional visibility to 2030 as soon as possible

# The cap is paramount

- The cap should be based on a formula that is a function of the EU 20% and 30% targets
- The formula should be simple and transparent
- Even before an international agreement is reached, the formula should be published so that businesses can make their own risk assessment of the caps
- Optimally, the formula would be published in the Directive
- As a minimum, the cap should be a reduction by the trading sector that is proportional to its emissions
- However, MAC analysis suggests that the trading sector can go deeper

# Auctions and allocation

- There are multiple levers, in addition to the cap, to drive low carbon investment:
  - Level of auctioning and how it increases over time
  - Basis for benchmarking
  - New entrant and closure rules
- Auctioning
  - The economic principle is that allowances should be auctioned and consequently, the burden of proof should be against free allocation
  - Why should the power sector not be 100% auctioned?
  - If an EU-wide set aside is not created for allowances to be auctioned, there should be an obligatory minimum level for Member States
  - The auction process at least should be centralised with timing aimed at improving liquidity early

# Benchmarks

- There is no place for grandfathering after 2012
- Benchmarking
  - EU-wide to provide a level playing field
  - Simple – base purely on carbon intensity
  - Must not result in over allocation for individual installations
- Where there is a combination of auctioning and free allocation in a sector, the mix should be determined by two factors only:
  - Carbon intensity
  - Exposure to international competition
- If there is an international agreement, the exposure to international competition will be limited

# Entrants and closures

- NERs
  - EU-wide set aside
  - As much auctioning as possible with some benchmarking on grounds of market entry and international competition
  - Unused NERs should be cancelled
- Closures
  - Transfer and sale should not result in loss of allowances

# Cascade of decisions