

October 5, 2012

Dear Commissioner Hedegaard,

IETA is a strong supporter of the EU's Emissions Trading Scheme (EU ETS) and welcomes the start of a debate around its future.

The EU ETS is succeeding in many respects, despite what is often portrayed in the media. For instance:

- The EU has taken leadership in putting a price on carbon. This has had a direct impact on the development of carbon markets in China, Australia and other parts of the world.
- The EU ETS provides a visible and credible price signal for operators. Industrial and financial market participants have learnt to operate under the scheme and to act upon the EU ETS signal.
- The EU ETS demonstrates how a market can achieve environmental targets in a transparent and flexible way: the EU is well on track to reaching its 2020 climate objectives of a 20% emission reduction and the EU ETS is a key contributor.
- The price fall reflects that the market is functioning, as it is the result of a steep reduction in demand, both present and anticipated, for emission allowances.

However, the unexpectedly deep and long recession combined with the impact of other carbon reduction policies has also led to a significant accumulation of oversupply in the market. This has encouraged some Member States to fall back on developing national and sub-national policies to encourage low carbon investment decisions at the expense of the level playing field and transparency that the EU ETS provides.

Moreover, national and regional funding streams that were based on the carbon price – such as the NER300 – have fallen severely short of expectation, putting back the development of key technologies for climate mitigation.

We recognise that backloading of allowances from auctions in phase 3 is a short-term measure to address oversupply. But our members seek more clarity as to what will happen to potentially backloaded allowances in the future and how this measure interacts with long-term structural EU ETS reforms. Without better visibility, we remain wary of the implications of this measure on EUA market development in coming years.

IETA believes that the market works best if supply can also adjust to changing economic circumstances in a transparent and predictable manner that operators can anticipate,

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and which removes the need for ad-hoc intervention. Currently, we understand that a structural supply-side change requires a revision of the EU ETS Directive.

As such, we urge the Commission to consider options for ETS design reforms that would prevent the build up of such extensive oversupply (or undersupply in growth times) regardless of whether or not backloading was introduced. Clarity on the path forward on such reforms is a sine qua non to anchor market expectations as to the future trajectory of the cap and the future design of this market. Different options for reform of the EU ETS are listed in attached paper for further consideration.

As to the backloading, we would like to share with you the following considerations.

As with every market sensitive announcement, it will be crucial to closely manage the communication process. Any proposal should be made public when sent to Member States and this date should be announced in advance.

The accompanying impact assessment should give an overview of the expected price impacts of different backloading scenarios, including any assumptions in the assessment and the impact further EU ETS reforms may have on the conclusions drawn in the assessment.

If the Commission is determined to return the allowances:

- Timing: IETA prefers returning the allowances in the latter years of phase 3, as participants will anticipate the increase in supply well before it starts. An early return date would weaken the effect of this measure. Returning all allowances in a single year seems however a risky strategy as the price crash from the sharp increase in supply could be severe.
- Volume: IETA agrees that backloading a higher volume in 2013 and lower volumes in the subsequent years would be preferable to backloading equivalent volumes each year. 2013 is for several reasons better supplied than subsequent years and this would also send a stronger signal of political determination.

A great deal of political capital will be expended to secure agreement on backloading. If the measure is judged to be insufficient and if the structural reform agenda remains too vague, this may lead to further volatility without restoring future market scarcity.

We look forward to an exchange with you on finding a stable and enduring path for future of the EU ETS.

Yours sincerely,
Dirk Forrister
CEO&President IETA



Options to reform the EU ETS: an analysis by IETA

Executive Summary

- The ETS works and has reduced emissions cost-effectively, it has set international precedent and example which is now followed by many other countries.
- The ETS also gives an investment signal over a long-time horizon as the emission reduction trajectory is fixed in legislation and is ultimately expected to support decarbonisation of European industry by 2050.
- As a result of an exceptionally strong recession and with a fixed number of allowances, the market is oversupplied. In order to be effective, the market requires scarcity over a period of time that operators can comprehend.
- When looking for fixing the scheme, policy makers must look for a comprehensive and market-based approach.
- There are several options for reforming the EU ETS to make it future-proof and the advantages and disadvantages of each option are further assessed in the table on pages 6-8. Annex 1 gives an example of an institutionalized safety valve limiting oversupply if it exceeds a certain threshold.

1. Introduction

This paper aims to provide a background for discussing potential reforms of the EU Emissions Trading Scheme (EU ETS) in light of the forthcoming first EU Commission report assessing its functioning. We propose a range of measures for discussion (table on pages 6 to 8, with illustration of option 9 in annex 1).

Companies must be able to understand the future ambition of emission reductions, which is difficult in an uncertain political environment. This impacts on the predictability necessary for future investment in the competitive electricity, iron & steel, cement, oil refining, chemicals and other production sectors. Accordingly, the allowance cap and the use limit for international offsets are largely fixed and determined in a political process to give planning certainty.

In contrast, the demand is set by the cumulative emissions of installations in the sectors covered by the ETS and activities of investors that serve to increase market liquidity. As demand declined strongly over the last years, an oversupply of allowances has built up in the system.

Some degree of oversupply helps industry and the power sector to control their risk exposure to the carbon prices through early purchases of carbon allowances. However, the perception of future scarcity is an important factor for a well-functioning market.



While we cannot know how the rule changes¹ will affect purchase behaviour, different analysts' forecast the market to remain significantly oversupplied in phase 3.

To restore the perception of future scarcity, policy makers must address a temporary, a fundamental and a coordination problem – all three will require addressing in a comprehensive package of reforms:

- The temporary problem is that the current surplus of allowances puts at stake the political viability of the EU ETS. Policy makers will not have the breath to sit out the restoring of scarcity under business-as-usual and might resort to national measures to advance low carbon legislation in their jurisdiction. This problem can arise again if economic conditions deviate significantly from expectations. Introducing more flexibility on the supply side through an institutionalized adjustment process could help prevent temporary problems in the future.
- The fundamental problem relates to the need to address the gap in long-term climate ambition as set out in the EU's commitment to the 2 degrees objective in the Copenhagen declaration at COP16.² To close this gap, policy makers need to adjust EU-wide emission-reduction target and most probably the EU-ETS through a political process, which could lead to a full review of the ETS Directive.
- The coordination problem emanates from the overlap of excessive multiple policy instruments for multiple objectives but all creating reductions of CO₂ emissions: mandatory CO₂ cuts in the ETS sectors, mandatory energy efficiency measures and mandatory renewable energy targets. The higher the overlap, the greater the need for policy interventions to adjust the schemes' baselines when higher than expected reductions occur through additional policy measures, or to amend future caps.

2. Options for ETS reform

In the short term the Commission's implementing powers are restricted by the terms of the ETS Directive. There are various regulations implementing the principles outlined in the ETS Directive however, that can be changed through a simpler process (Comitology) within a couple of months as long as they respect the initial mandate through the ETS Directive and secure agreement from Member States.

Reflecting this set-up of the legislative process, ETS reform options differ strongly when looking at the short or longer term. In the short term, and without amending the ETS Directive, policy makers are limited to the Comitology procedures sanctioned by the current Directive. In the mid-to long term, a whole range of additional measures could

¹ The allocation process is considerably tightened in phase 3 with full auctioning for the power sector (except for transitional purposes) and EU-wide efficiency benchmarks for (partial) free allocation to industry.

² unfccc.int/resource/docs/2009/cop15/eng/l07.pdf



be envisaged, subject to passing the extended European and national legislative processes.

There are clear rules that should be respected before entering any reform process:

- keep up the market-based character, i.e. let demand and supply define the price;
- ensure the perception of scarcity in the scheme returns over a period of time that operators and investors can act on, which should include clarified milestones for the climate trajectory towards 2050;
- introduce any changes through well-established predictable regulatory processes, with an appropriate stakeholder consultation;
- announce changes well in advance to allow market expectations to adjust without introducing unnecessary volatility;
- be clear on objectives and communicate them in a transparent, non-equivocal manner;
- ensure consistency between all elements of EU Climate & Energy policy;
- avoid piece-meal approach and competitive distortions.

Moreover, a main element of the reform should be carbon leakage prevention pending an international agreement providing a fair competitive position for trade-exposed industries.

The table on pages 6-8 presents a high-level analysis of possible reform options in the order of how long we would expect implementation to take.

At this stage we do not have a preferred approach though we would welcome further dialogue with the Commission once they have a clearer view of their preferred measures.

| Option | Description | Pros | Cons |
|---|--|---|--|
| 0. Do nothing | No change to current rules. | Keeps up predictability of rules in place. Preserves market-based approach. No intervention precedent. | Phase 3 oversupply reduces market absorption capacity and affects market functioning. Credibility of policy makers to act upon announcements at stake. |
| 1. Back-loading of auction volume | Temporarily withhold volume from auctions, return to market before phase end. | Only feasible short-term measure to address oversupply. Gives time to work out longer-term structural changes. Less pressure to 'go national/regional'. | Introduces greater political uncertainty. Return of allowances is destabilizing. |
| 2. Offset use restrictions | Further restrict types of projects approved for offset use (precedent: HFC23, N2O from adipic acids). EC commissioned study had pointed to other candidates. | Has a precedent. Gives more space and hence drives up price for eligible credits, supporting EUA price. | Early surrender to beat any deadline contributes to today's oversupply. Installations can make use of other sources of supply to cover their use limit. Takes away the price on banned international emission reduction initiatives. |
| 3. Permanent Set Aside | Permanently withhold volume from phase 3 auctions, a. cancel a certain amount; b. cancel in phase 4. | Supply adjustment to take into account crisis & overallocation effect. Without an adjustment, the system will remain long for years to come. | This represents a change of agreed phase 3 rules. From an investment perspective, it is more relevant to clarify phase 4 rules (offset limits, free allocation, etc). The risk of getting the volume wrong remains. |
| 4. Pricing mechanism (Auction Reserve Price - RP) | Do not sell/postpone allowances in auctions below RP. Volume could be reintroduced at next auctions. | As share of auction increases, enhances scarcity when secondary market price below RP. | Introduces concept of a price target with risk of over-achieving objective. Difficulty of setting the price. Who would set it with what criteria? |
| 5. Banking rules | a. define a % of allowances per installation that cannot be banked into the next phase; b. restrict % of allowances to pure compliance, ban from on-sell. | Do away with over-supply in a predictable manner. | Damaging to market confidence and efficiency of the scheme. Banking provision is essential to integrating the carbon price signal in investment decisions. |

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| Option | Description | Pros | Cons |
|-----------------------------------|---|--|---|
| 6. Climate objectives /trajectory | Change cap in line with 2050 Roadmap. Most likely proposal right now is a definition of a climate target for 2030 (based on current trajectory: -40 % vs 2005). | Current trajectory insufficient to meet 80% domestic emission reduction in EU by 2050, required to meet 2 degree goals. Transparent decision, market can react, no recalibration/fixing. | If independent from global progress, carbon leakage concerns. Will not solve the short- term issue and supply remains unresponsive to demand changes. |
| 7. Extending Demand | Add new sectors (transport/households/ agriculture) and gases, link to other schemes. | Extends abatement across larger scale of sources. | Many small sources makes compliance a big burden relative to emissions, and less responsive to market price signal. Difficulties in reporting, monitoring and verification of non CO2 gases such as CH4 in agriculture. |
| 8. Review cap setting process | Process of deliberate decisions by an independent authority or automatic adjustment process of cap, based on publicly known formula tracking economic growth in ETS sectors. Yearly review, change applicable in a 5-year horizon (as foreseen in Australia). | Better manage and prevent build-up of oversupply/excess scarcity. Predictable correction that can be anticipated by market players. | Risks of politicization if formula leaves scope for interpretation. If institutional framework not well defined, could lead to interventionism, rather than adjustments to structural changes. Risk to compromise integrity of absolute cap in case of sustained high growth. |
| 9. Oversupply safety valve | Adjust trajectory towards a pre-set cap – less auctions when oversupply reaches threshold, more if again below threshold. At end of trading period, the reserve is released back or a legal decision is taken to bank the amount of allowances. See annex for illustration. | Prevents need for future ad hoc adjustments and enhances predictability. Ensures that the systems' scarcity principle is upheld. Relief to industry in times of unexpected economic growth. Still ensures the environmental objective. | Risks of politicization if formula leaves scope for interpretation. Leads to interventionism, rather than adjustments to structural changes if institutional framework not well defined. Hampers counter-cyclical effect of ETS: reduced costs when economic conditions are difficult and do more when you can afford it. |



| Option | Description | Pros | Cons |
|--|---|--|---|
| 10. Ex-post adjustment ³ | Allocate ex-ante on basis of benchmarks, adjust ex-post to production volumes. Once verified production data available, previous year's allocation gets adjusted upward or downward. | Allows cap adjustments for positive and negative industrial growth and decreases risk of carbon leakage. Prevents undue windfall profits – a hindrance to rationalisation. Enables growth of the more carbon efficient products and producers. Operator fully know their position. | Puts into doubt reaching of environmental objective (can be mitigated by State-level offset purchases). Non-trivial implementation for combustion installations and complex benchmark sectors. |
| 11. Common currency for energy & climate targets | RES and EE targets are set in terms of CO2 equivalent reductions using simple baselines (e.g. g CO2/Kwh); ETS cap is set taking fully into account the RES & EE CO2 reduction targets; EUAs (common currency) can be used to meet the RES & EE targets. | Avoid excessive costs in meeting the RES and EE targets and also cause the price of carbon to adjust to the economic optimum. Market integration. | Design issues: conceptual difference, different objectives, different sources covered. Problems of linking the new currency with foreign schemes. Lack of transparency and complexity. Market access unclear about the impact; potentially difficult for them to adjust. |
| 12. Institutional Set up (carbon bank) | Introduce an independent body, separate from political influence, responsible for oversight and management of the carbon market to deal with over-/ undersupply. ⁴ Responsibilities could also be more far-ranging and include resetting the linear-reduction factor. | Depoliticizes, adds flexibility and builds on finance expertise. Should enhance operational efficiency and market oversight; Greater degree of accountability and transparency in decision-making; Establishes a guarantor of last resort. | Criteria and process for intervention challenging to get right. Undermines the system if intervenes too much and too often. Difficult to project demand for allowances. Risk of political dislocation and who puts in the political capital? |

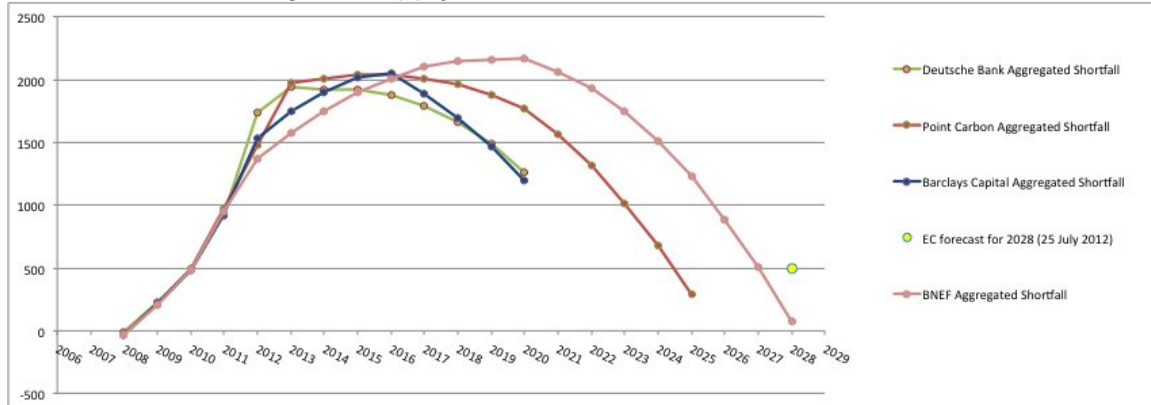
³ Partially already covered through the possibility to apply for additional allowances in the case of a physical extension or to forego allowances when production decreases by over 50% (ETS Directive Article 10a, Comitology Decision on Benchmarks, Chapter IV).

⁴ Sustainable Prosperity (2011). A Carbon Bank: Managing Volatility in a Cap-and-Trade System, p. 2

Annex 1: Illustration of supply-side adjustment

Peak oversupply in the EU ETS is predicted to reach around 1700-2000 million EUAs in mid-phase 3 (see chart 1) - about a year of supply - but with a continuing downwards trajectory into the next phase when scarcity is modeled to resume.

Chart 1: Accumulating oversupply in EU ETS (2008-20)

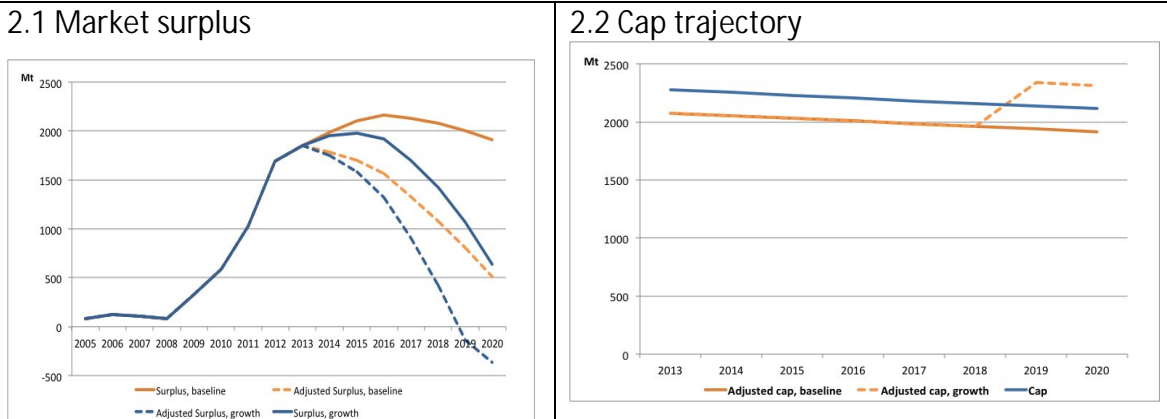


Source: IETA based on Barclays, Deutsche Bank, Point Carbon, European Commission.

Note: Accumulated gap between demand for emission permits and the cap incl. aviation and offset use.

The introduction of a safety valve would consist in picking a certain threshold (e.g. 1 Gt) which would trigger a slow down of the yearly auction volume at a pre-set rate (e.g. 200m) and for as long as oversupply remains above the threshold. The amount set aside could be returned at a pre-set rate (e.g. 200m) when accumulated market length falls below the threshold. A certain delay in implementation is necessary to get access to verified emissions data for year N, and to announce a change in the auction calendar for N+2. At the end of a trading period, the reserve is released back or a legal decision is taken to bank the amount of allowances, depending on economic circumstances.

Chart 1 – 1 Gt excess allowance safety valve and both-ways adjustment process



Source: IETA based on market analysts' projections for cap trajectory, emissions demand and offset use.

Note: Growth scenario is assuming 2% annual growth in verified emissions as of 2014.

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