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Vattenfall's response to the European Commission's consultation on options for a structural reform to strengthen the EU Emissions Trading Scheme (EU ETS)

In its first annual Carbon Market Report[1] published on 14 November 2012, the European Commission elaborated on six options for structural measures to tackle the large imbalance between supply and demand in the EU ETS market and to improve the functioning of the system. On 7 December 2012, a formal public consultation was initiated through which the Commission seeks to obtain stakeholders' views on the specific reform options elaborated in the report.

This paper constitutes Vattenfall's response to the European Commission's inquiry.

Vattenfall's response in short

- **Vattenfall remains strongly committed to a centre-piece EU ETS** as one of the most long-term, cost-effective, environmentally reliable and internal market compatible policies at hand to significantly reduce the GHG emissions in line with the EU's climate targets.

- Out of the six structural measures elaborated by the European Commission in the public consultation document, Vattenfall gives **highest priority to Option (C) "Early revision of the annual linear reduction factor"** connected to the adoption of an intermediary climate target for 2030.

- To address the large surplus of allowances already accumulated in the market, **Vattenfall supports Option (B) "*Retirement of a number of allowances*"** through a distinct one-off measure in the form of a permanent set-aside with a significant impact in Phase III.

- Vattenfall clearly favours a more economy-wide carbon market which can improve the overall efficiency of the policy. Thus, **Option (D) "*Extension of the scope of the EU ETS to other sectors*" is a step in the right direction**.

- Linking the EU ETS towards similar trading schemes in other regions of the world is also strongly recommended. However, further restrictions through **Option (E) *Limit access to international credits* is discouraged** since it would only increase the costs for reaching a certain target and reduce the interest in combating climate change by global cooperation.

- There is an obvious risk that **Option (F) *Price management mechanisms* can reduce the EU ETS's credibility as a market instrument**. Still it merits to be further investigated whether some kind of "safety-net" needs to be created to protect against complete erosion of the CO2 price in exceptional events while still preserving the policy's basic functioning. .

[1] COM(2012) 652 final, *The state of the European carbon market in 2012*

General comments

In the response to the Commission's public consultation on the proposal for backloading of allowances in Phase III (as submitted on 16 October 2012), Vattenfall questioned the effectiveness of the backloading idea if carried out in isolation (i.e. without an associated permanent set-aside or change of the long-term ETS cap trajectory) and requested a more profound discussion on a structural reform of the EU ETS policy framework.

On that backdrop, Vattenfall warmly welcomes the Commission's initiative to consult on measures of long-term relevance as well as its ambition to engage stakeholders in further talks dedicated to this subject in the course of 2013. This is also an important initiative to show the degree of political commitment to support the EU ETS as the centre-pillar of the EU's climate policy.

As advocated already in Vattenfall's response last autumn, the structural reform should bring forward an intermediate climate target for 2030, in line with the EU's long-term decarbonisation objective for 2050, with a corresponding adjustment of the annual linear reduction factor which determines the decline of the EUA cap trajectory. A permanent set-aside of a subset of the allowances originally intended for auctioning in Phase III could also be considered in order to address the currently overflowed market. This would help to safeguard the EU ETS' role in the strive to decarbonise the energy system and avoid that this important instrument becomes further sidelined by other less cost-efficient and poorly harmonized policy interventions.

Vattenfall is convinced that the EU ETS is capable of delivering very deep cuts in GHG emissions and considers that it should be the principal instrument to promote low-carbon measures to achieve the EU's long-term decarbonization objective. The EU ETS creates a uniform price on CO2 emissions and ensures that the overall emissions are capped on a level consistent with the adopted climate targets. Thereby it helps to deploy a wide range of cost-effective technologies and response measures which are needed to achieve the overall target. Moving towards a greater utilization of the EU ETS will reduce the societal costs associated with reaching the target and this will become even more important when the required level of efforts increases over time.

In order for the EU ETS to meet the expectations of becoming the centre-pillar within EU climate policy it is important that the ambition level set by the long-term ETS allowance cap trajectory is consistent with the society's overall objective of reducing GHG emissions. The current EU ETS cap, however, falls short of the EU's long-term climate objective (80-95 % by 2050) and therefore the highest priority is given to *Option (c) Early revision of the annual linear reduction factor*. Since this will not be sufficient to address the large imbalance and surplus accumulated in the market until today, there is also a need for a distinct one-off measure in the form of a permanent set-aside with a significant impact in Phase III. Thus, the second highest priority is *Option (b) Retiring a number of allowances*.

To avoid incoherencies in the EU climate and energy policy framework, the overall post-2020 policy regime needs to be developed in a single and coherent process. Turning the EU ETS into a key driver for meeting the EU's climate objectives requires that other policies should be carefully used in order to not further undermine the functioning and effectiveness of the EU ETS. Moreover, if the common objectives shall be met in a consistent and cost-efficient manner, it is not enough to ensure that the EU ETS does not become severely distorted but it must also be accompanied by a much greater utilization of the internal energy market.

Specific comments on the structural options outlined by the Commission

In addition to the general priorities and reasoning outlined above, Vattenfall would like to provide some more detailed comments on the six specific options for structural reform elaborated in the Carbon Market Report from November 2012.

Vattenfall encourages the Commission to follow up with a quantitative analysis on what the different options mean in absolute figures of EUAs allocated between 2013 and 2050. At present many of the options are only conceptual and when the Commission provides numbers it is only relative figures for the whole EU and still unclear what is the respective starting point of the proposed reductions and the part carried by EU ETS sectors. A thorough consideration of the different options requires more detailed information about the measures in question.

Option A: Increasing the EU reduction target to 30 % in 2020

Vattenfall believes that the ETS cap should be adjusted to be more in conformity with the EU's long-term climate objective (80-95 % reduction by 2050 relative to 1990). What is important in that respect is to define a climate target for 2030 leading to a long-term trajectory which makes the allowance cap in the end arrive at a level which is consistent with the EU's goal for 2050. Defining the appropriate constraint necessary for the policy to deliver on the long-term climate target is more important than making a short-term alteration of the 2020 target. Changing the 2020 target could instead both result in confidence problems and have negligible impact on the CO2 emissions until 2020 bearing in mind the companies' limited scope to change their investment plans for the short time until 2020.

Option B: Retiring a number of allowances in Phase 3

Vattenfall supports a permanent set-aside in Phase III provided that it is well-balanced and clearly defined as a one-off measure. A cancellation of a certain amount of allowances from the originally planned auctioning volumes in 2013-2020 would be a clearly more meaningful response to address the surplus situation than simply backloading (re-shuffling) the supply within the period. Backloading can only be justified as a first step within the context of an ambition to later retire the same allowances through a subsequent decision. Otherwise there is an obvious risk that the measure only creates additional uncertainty for the market participants without having any price impact, at least not a sustained one.

Option C: Early revision of the annual linear reduction factor

Out of the structural measures presented by the Commission, Vattenfall gives highest priority to an adjustment of the annual linear reduction factor of the ETS cap trajectory connected to the adoption of an intermediary climate target for 2030. This would provide more certainty about the policy framework beyond 2020 - a year which is already in the rearviewmirror for most investment decisions being made in the energy sector today. The precise figure should be set with a view to ensure that the trajectory of the ETS cap is in line with the EU's long-term climate objective for 2050 (80-95 % reduced emissions compared to the level in 1990) as illustrated by the Roadmap for a Low-carbon Economy in 2050.

Option D: Extension of the scope of the EU ETS to other sectors

Vattenfall supports the ambition to gradually expand the EU ETS policy to include additional sectors of the economy. A broader scope of the cap-and-trade policy would increase the cost-efficiency of the overall climate policy and improve the functioning of the market through increased liquidity and more stable price development. Linking the EU ETS towards similar schemes in other regions (such as Australia from 2015) has the same merits as well as other positive side-effects in terms of competitiveness and a more global response to address the climate. With regard to a potential future linking it is also important to stick the current scheme together and not split e.g. the energy sector and industry sectors into separate regimes. Such a split would deteriorate the efficiency of the ETS and require that more expensive abatement measures than necessary have to be used to achieve the same climate impact.

However, it is not sure that neither the expansion to another sector nor linking towards other schemes would contribute to resolving the surplus in the market. The resulting impact on the supply and demand balance in the merged scheme can go in any direction depending on the stringency and abatement costs within the added activities. A decision to expand the current scheme to additional sectors must also be preceded by an assessment of the administrative costs which must be put in relation to the improved economic efficiency associated with the measure.

Option E: Limit access to international credits

Vattenfall believes in the idea of a global carbon market. This can be initiated through direct linking of trading schemes or admittance to use commonly accepted flexible mechanisms. Restricting the access to international credits would be harmful with respect to this development as well as the overall cost-effectiveness of the policy complex. Further limiting the operators' access to relatively cheaper CO2 abatement options just to inflate the CO2 price is not advisable because it would only increase the societal costs without any positive effects on neither the environmental outcome nor the willingness to engage in more global cooperative actions on climate change. The existing link towards the Kyoto Protocol's project-based mechanisms have been particularly useful in the sense that it has extended the efforts to tackle climate to also regions without any restrictions on CO2 emissions, channelled significant amount of financing to the developing countries and spread the knowledge about market-based policy approaches in general.

Still certain *quantitative* limits on the use of offset credits remain justified in order to ensure a reasonable balance between reductions that occur in installations directly covered by the EU ETS and reductions achieved in third countries by financial support from the EU ETS operators. In addition, *qualitative* criteria would be needed to ensure that the offset credits come from projects that have the same high environmental integrity as the reductions made within the EU ETS.

Option F: Discretionary price management mechanisms

The EU ETS is by definition a volume-oriented instrument. Once the politicians have decided on the highest allowed emission level as defined by the ETS cap, the market ensures that the actual GHG emissions are contained under this restriction at lowest possible cost. There is an obvious risk that adding a price management tool (e.g. price floor, price cap or central bank) could introduce new scope for political subjectivity and thereby harm the credibility of the EU ETS as a market instrument. Still it could be further investigated whether it is appropriate to create some kind of "safety-net" which avoids at least a complete erosion of the CO2 price in exceptional events, while preserving the cap-and-trade principle's functioning and keeping the regulatory uncertainty in the market to a minimum.

Policy makers should not underestimate the difficulties involved in determining the "right" CO2 price to achieve a desired CO2-reduction. The uncertainties about fundamental factors (such as e.g. future fuel prices) make the assessment of which CO2-price is needed to achieve a certain GHG emission reduction even more complicated. Introducing regulated EUA prices carries a risk of adding another source of regulatory risk in the sense that also the EUA price perimeters become sensitive to repeated political interventions – in the same way that the ETS allowance cap is already from the outset.