

## Consultation on the 2015 International Climate Change Agreement

### *Response by Scottish and Southern Energy plc*

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- 1. How can the 2015 Agreement be designed to ensure that countries can pursue sustainable economic development while encouraging them to do their equitable and fair share in reducing global GHG emissions so that global emissions are put on a pathway that allows us to meet the below 2°C objective? How can we avoid a repeat of the current situation where there is a gap between voluntary pledges and the reductions that are required to keep global temperature increase below 2° C?*

The EU's climate and energy programme was informed by the IPCC reports of 2007. This science-led approach allowed policymakers to define long term policy signals to inform national and regional governments, organisations, citizens and investors. Only consistent long term policy signals will create momentum for low carbon investment, avoid carbon lock-in and move all countries towards significant mitigation. Future policy should continue to be science-based.

There are various strategies which can contribute to wider engagement and substantive international participation. For example, 'smart' treaty design options could create incremental obligations for emerging economies, conditional financial contributions, recognition of binding domestic programmes in lieu of binding international commitments and built-in review dates for the main provisions of the agreement. Combined with biennial science updates and enhanced reporting of annual emission statistics, these concepts are thought to offer substantial incentives and mechanisms to enhance international collaboration.

- 2. How can the 2015 Agreement best ensure the contribution of all major economies and sectors and minimise the potential risk of carbon leakage between highly competitive economies?*

As above, treaty provisions to gradually bind emerging economies are important to regulate their contribution to global emissions. The transition of those countries (and subsequent groups of emerging economies) to 'bound' status under the agreement will give clear long term locational signals to energy intensive industries which would reduce the focus on carbon leakage.

To reach agreement, an option is to establish an overarching non-binding low carbon trajectory, alongside substantive legally binding measures that countries will impose in order to reduce emissions. As such, an agreement whereby the various emission trading schemes will be coupled or linked would be highly valuable. These linkages should be achieved in a way that is sensitive to the differences between individual trading systems, to avoid flooding markets with carbon credits. Lessons can be learned from the experience of including international credits in the EU ETS.

3. *How can the 2015 Agreement most effectively encourage the mainstreaming of climate change in all relevant policy areas? How can it encourage complementary processes and initiatives, including those carried out by non-state actors?*

The UK's Committee on Climate Change has a wide mandate to review the adequacy and mainstreaming of climate objectives across all relevant policy areas. Its approach and its 5 year track record appear to offer a useful model to be delivered under the Convention. It has successfully communicated specialist information to non-specialist audiences which is vital to maintain the social and political willingness for action. However, crossover with biodiversity, sustainability and general economic development policy is unavoidable and would require strong collaboration and cohesion amongst distinct UN programmes. That effort would be worthwhile in order to establish a robust, coherent, expert and independent advocate better able to report on the adequacy of the agreement.

4. *What criteria and principles should guide the determination of an equitable distribution of mitigation commitments of Parties to the 2015 Agreement along a spectrum of commitments that reflect national circumstances, are widely perceived as equitable and fair and that are collectively sufficient avoiding any shortfall in ambition? How can the 2015 Agreement capture particular opportunities with respect to specific sectors?*

SSE agrees with the Commission's assessment that the agreement must be legally binding. As suggested above, options to engage countries through gradually binding commitments (depending on achieving specified income thresholds and / or reaching specified absolute emission levels) offer scope for an innovative and effective agreement. Again, this creates strong long term policy and investment signals, avoiding carbon lock-in, tackling carbon leakage aspects and providing a stimulus for innovation. Coupling or linking various emission trading schemes should be promoted, as well as continued development and adoption of such schemes.

5. *What should be the role of the 2015 Agreement in addressing the adaptation challenge and how should this build on ongoing work under the Convention? How can the 2015 Agreement further incentivise the mainstreaming of adaptation into all relevant policy areas?*

The agreement must continue to support ambitious adaptation programmes to build capacity within least developed states and states at particular risk from climate impacts such as the AOSIS states.

6. *What should be the future role of the Convention and specifically the 2015 Agreement in the decade up to 2030 with respect to finance, market-based mechanisms and technology? How can existing experience be built upon and frameworks further improved?*

The EU's flagship emissions trading scheme has underpinned the growth of global carbon markets and delivered tangible emission reductions through the CDM and JI. Despite well-documented problems to which SSE has offered specific proposals on structural reform (see attached annex), the markets offer efficient price discovery, a stimulus to technology and through the linking directive (2004/101/EC) – an emergent global market. The practical outcomes of certain CDM and JI projects have been criticised by some commentators and excess certificates have played a part in depressing EU ETS prices. Their working should therefore continue to be improved. The agreement should preferably extend beyond 2030 and ideally go as far as 2050 to give appropriate long term investment signals.

7. *How could the 2015 Agreement further improve transparency and accountability of countries internationally? To what extent will an accounting system have to be standardised globally? How should countries be held accountable when they fail to meet their commitments?*

SSE's suggestion above at Q 4 - relating to an international body mandated in a similar way to the UK'S CCC – can underpin measurement, reporting and verification by creating an authoritative body charged with reviewing the adequacy of efforts under the broad climate programmes delivered in support of the agreement. The Commission noted the scope to suspend non-compliant countries from the carbon markets. This incentive for compliance will increase over time.

8. *How could the UN climate negotiating process be improved to better support reaching an inclusive, ambitious, effective and fair 2015 Agreement and ensuring its implementation?*

SSE is not well placed to comment on this point.

9. *How can the EU best invest in and support processes and initiatives outside the Convention to pave the way for an ambitious and effective 2015 agreement?*

The EU should pursue plurilateral initiatives and if appropriate, propose these for migration into the overarching UNFCCC framework.

DRAFT

Annex

## Discussion Note

# A Stability Mechanism for the ETS

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## 1. The Issue

The fundamental issue faced by the EU-ETS is the absolute fixed nature of the cap. Unlike almost any other market, the volume supplied responds neither to changes in price nor demand. The effect of this is exacerbated by demand behaviour. An emissions credit has no intrinsic value to consumers in its own right; and so at many price levels, price is not the primary driver for demand. For example very low EUA prices do not stimulate extra demand in the way they would for most goods. By contrast other influences such as economic activity, renewable energy incentives, energy efficiency legislation (which are difficult to predict “ex-ante” when the cap is set) have a profound effect on demand at all price levels.

In economics terms, the ETS has a vertical “*supply curve*”, and a near-vertical (but unpredictable) “*demand curve*”. With this dynamic, prices are inherently unstable; and ultimately it is highly likely that either:

- Allocations are higher than underlying demand, regardless of price; and so prices sink to very low nominal levels (“option value” only).
- Allocations are lower than underlying demand – potentially sending the market to distress levels once sensible short-run abatement opportunities are exhausted.

In the event the former has occurred in Phase 2, with around 900mtes of over-allocation, and EUA prices currently around €3.00/te. As a result:

- No “signal” is offered by the market to abate carbon dioxide emissions.
- The relative insignificance of emissions prices, relative to the high value of fossil fuels – and renewable subsidies - means it is not a central driver to investment decisions.
- The validity and future of the whole ETS scheme is questioned.
- Governments will not raise the revenue anticipated from ETS auctions.
- Uneven additional carbon tax regimes appear increasingly likely to proliferate.

## 2. “Ad hoc” interventions and beyond

On 3 July, it is expected that the Commission will re-introduce the concept of back-loading to answer the most immediate issue of over-supply. We hope that the Commission secures an agreement on back-loading – that will represent a real message that volumes have to respond to circumstances; it is to be welcomed. However, we also suggest that multiple “back-loadings” introduced (twice) to respond to circumstance is not a perfect solution long term:

- It doesn’t give a clear signal to the market
- It implies political “interference” which is never perfect in any market

So we wish to propose an **outline** of what the Commission might choose to do on a permanent basis, with **the design of Phase 4 mechanism** specifically in mind. These ideas are market-driven but have regard to the perceived *real politik* of these debates.

## 3. Adjusting auction volumes in response to over-allocation

The simplest measurable and objective evidence of over-allocation is surplus supply of EUAs in the registries. We suggest that any mechanism to modulate supply in the event of over-allocation should involve reducing forthcoming auction volumes to reflect the over-allocation measured this way.

In essence, the idea would be that if there were too many allowances in circulation (on the register) one would **withhold allowances** from the auction, placing them instead into a new “**surplus reserve**”. In certain circumstances, if scarcity were re-established, there should also be a facility to release allowances in the surplus reserve to the market. This poses three essential questions:

- How do you withhold them?
- How do you return them?
- Who does this and how do you establish the rules?

### **Withholding allowances**

It is possible to envisage a range of precise methods to adjust auction volumes in response to evidence of over-supply on the registry. For example:

- Registry observations could be made annually, after the surrender date – or another date.
- The target registry balance could be larger or smaller (too small means not enough base for liquidity, too large means too heavy a balance sheet onus on the market)
- The target registry balance could be an absolute figure, or a proportion of annual demand.
- There could be a tolerance threshold on the target balance (e.g. +/-10% etc.), or not, before adjustments begins.
- Adjustments could be staged immediately, or over a period to avoid “sudden jolts”.

### **Return of allowances to the market**

In some senses the more important question is how and under what circumstances the surplus reserve is released to the market. Again several methods are possible, which might include one or more of the following elements.

- Observations of falling registry balances could be used as evidence of underlying demand recovery; and auction volumes could be increased accordingly (i.e. analogous to the way they were withheld in the first place). Economically this has some weakness: as supply may on occasion be increased in a falling market, and the stabilising impact of the auction reductions may be diluted or negated.
- Surplus reserve volumes could be auctioned with a simple reserve (floor) price set at a level at which the ETS is no longer “dysfunctional” (i.e. the demand curve is not near-vertical). The issue here is that this level is subjective, and would have to be determined ex-ante.
- Surplus reserve volumes could be auctioned with a reserve (floor) price set at a relative price level. For example if the floor price was set at the average market price over the previous two years, then the surplus reserve would be available to the market as long as price recovery was already underway. Alternatively the floor could be the average market price in the last year in which there were no auction reductions. In some ways, this appeals most from an economic standpoint as it ensures that supply rises when price is rising (like a normal market).
- Surplus reserve volumes could be permanently set-aside after a pre-determined “shelf life”. i.e. if the over-hang appears structural and permanent, and price or demand recovery has not occurred.

### **Who and How**

The rules for withholding and returning allowances could be strictly mathematical and mechanistic; or they could involve subjective judgements and discretionary latitude from a mandated authority.

Likewise the “surplus reserve” could be held and released by a central body acting on behalf of member states; or it could be held and released in parallel parts by member states.

**However volume is withheld and released, we believe that it will offer an improvement on the existing inflexible ETS.** We also prefer a well designed and clearly defined mechanism over discretionary intervention, as this should add to market confidence, and hence price stability.

#### **4. Potential for an absolute cap and floor**

Withholding and returning auction volumes in response to over-allocation evidence does not preclude setting an absolute minimum and maximum price for the scheme: a “cap” and a “floor”.

- A floor could be implemented simply by stipulating a minimum price at auction (with unsold allowances added to the reserve, perhaps).
- A cap could be implemented by unrestricted sales of additional allowances at the cap price; with proceeds used to fund more expensive abatement schemes (CCS) and perhaps CDM purchases.

Under the current Directive, the Commission has an undefined mandate to intervene in the event of extreme high prices, but not extreme low prices. So the current ETS has no floor, and an undefined or subjective cap.

We recognise that price management schemes have proved unpopular in consultation, but still believe that adding a clearly defined cap and a floor – even if they are set at extreme high and low levels respectively – would provide additional benefit by avoiding dysfunctional market behaviour at either extreme. To put it another way: they would improve the shape of the “supply curve”, and add to stability.

#### **5. Economic benefits of a more stable and robust mechanism and price**

A well designed emissions market should be more efficient, targeted, and effective than local taxes and incentives. The main benefit of a stronger and more inherently stable EUA price is that it would provide a more reliable signal for investments, which applies evenly across the EU. Investments such as those in renewable energy infrastructure are exactly what the EU economy needs at present.

Conversely the costs to industry are not excessive (€10/te is equivalent to €4.30 per barrel of oil); and where competitiveness against imported products is comprised the issue can be addressed in other ways (free EUA allocations, levy on imports etc).

#### **6. Next Steps**

We present these ideas for discussion purposes. They are informed by discussing with various environmental academics and by a parallel debate within IETA, but they are our own considered thoughts. They do not represent a formal proposition; if of merit, we would be very happy to participate in a debate to refresh and refine them.

However, the debate progresses it is essential that the EU-ETS, the world's flagship trading mechanism, demonstrates an ability to address the cliff-edge nature of its supply and, therefore, the volatility of its pricing. Progress towards a more visibly robust Phase 4 mechanism should on its own stabilise Phase 3 market prices – regardless of whether ad hoc measures of back-loading and set-aside are successfully implemented – and so the sooner it is made the better.