

COMMENTS ON THE REVIEW OF THE EMISSIONS TRADING DIRECTIVE

29 of June 2007

Now that the Emission Trading Directive review is in progress, Iberdrola wants to show its support to the European Emissions Trading Scheme (EU ETS) as the most efficient way (lowest cost) of achieving important reductions on CO₂ emissions. However, Iberdrola is of the view that some issues can be improved.

Apart from some technical issues that can be improved in the EU ETS, Iberdrola has two main concerns regarding the outcome of this review process:

- The EU ETS should deliver a clear long term price signal that gives a stable and sufficient incentive to invest in the low carbon technologies needed to achieve the long term emission reduction targets.
- The EU ETS should create an European level playing field for investments, avoiding distortions at Member State level.

These two concerns are going to be the key objectives of Iberdrola's comments. Taking this into account, we are going through some of the issues that are going to be assessed in this review process as stated in COM(2006) 676.

Further harmonization and increased predictability.

Iberdrola considers this issue as the most important one in the EU ETS review.

Regarding the setting of the cap, there are two points:

- An overall EU-wide cap should be established at EU level, so that EU-wide caps for every sector could be derived from it, in order to avoid more stringent burdens allocated to the EU ETS sectors in some Member States compared to others. This is crucial, so that a level playing field can be built.
- It is very important to know the total number of allowances allocated in the long term, so the establishment of the total EU-wide cap is imperative. This is the very first step to increase predictability and to give a long term signal in order to achieve, through banking, a stable price signal. As assets in the electricity sector recover their investment in periods of time between 20 and 40 years, knowing the total amount of allowances involved in the scheme for

the longest possible period is crucial in order to take proper investment decisions.

- Although the determination of the cap can be considered the most important issue in order to give a long term price signal, there are many other elements that affect this price signal:
 - Incorporation of other sectors and gases.
 - Limits (or the absence of them) to the total amount of project credits from CDM/JI to be accepted in the scheme.
 - Acceptance in the schemes of credits from domestic projects.
 - Subsidies (including allowance allocation) to any particular technology, type of installations, etc.
 - Linking with other schemes.

All these issues affect the long term CO₂ price, as they modify, either the emissions reduction cost marginal curve, either the emissions reduction objective to be achieved by the EU ETS sectors, or even both of them. Therefore,

- Changes in how these issues are dealt within EU ETS should be minimized, in order to create a stable environment that can give enough incentives for going ahead with investments in low carbon technologies.
- Any change made regarding these issues should be clearly signalled well in advance in order to avoid stranded investments.

Regarding allocation of allowances to sectors and installations:

A fully harmonized allocation methodology should be applied at European level in order to create a level playing field and avoid economic distortions derived from 27 different National Allocation Plans.

Iberdrola supports that free allocation should in principle be restricted to sectors that are subject to international competition and cannot pass through the cost of CO₂ to their customers. Therefore, no free allocation should take place for the rest of the sectors, in which full internalization of carbon costs can be passed to market price.

Free allocation can be considered a subsidy. Operational variables of the installations (production, emissions, fuel consumption, etc) are totally independent of allocation, which, therefore, can be considered a fixed income. Therefore, allocation only affects investment and closure decisions, and not any other operational decision as, for example, production. Taking this into account,

it seems sensible that if any free allocation is finally granted to the electricity sector, it should, at least, keep the incentive given by CO₂ price to invest in the less emitting technologies.

The only way to maintain this crucial incentive is to allocate free allowances by installed production capacity. This is equivalent to apply product benchmarks considering the same operational hours for all installations entitled for free allocation. In general, product benchmarks are better for less emitting technologies. Any other type of allocation based on fuel or technology based benchmarks gives additional support to invest in more emitting technologies.

Regarding new entrants and closures:

A fully harmonized allocation rules for new entrants and closures should be established at EU level. Allocation rules affect investment and closure decisions directly, so this harmonization is necessary in order to avoid distortions regarding investment and closure issues through the EU.

In order to avoid discrimination, new entrants should be treated equally as the rest of installations. In this way, the same level of subsidy derived from allocation will apply to installations in similar circumstances.

Regarding the allocation rules that should be applied to closures, if the objective is to give incentives to close old high emitting installations, it is much better to reduce their free allocation significantly (or even giving them no free allocation at all), instead of giving them standard free allocation and then maintaining it even if these installations close. There is no point in giving a standard allocation to old amortized high emitting installations.

The scope of the Directive

As one of Iberdrola's main concerns is that the EU ETS should be capable to give a long term price signal that incentivise investment in low carbon technologies, any incorporation of new sectors to the scheme should be clearly signalled well in advance and done gradually in order to avoid price shocks.

CO₂ price shocks could drive concerns on the profitability of investments. Most of the incumbents with more emitting technologies are mainly worried about "upwards" price shocks. However "downwards" price shocks derived from regulatory changes are even more important. They generate an unstable situation that can jeopardize investments in low carbon technologies.

Then, any new incorporation to the scheme should be carefully implemented. Iberdrola supports the incorporation of new sectors and gases, if it is cost effective. It is important that a cost-benefit study should be carried out, in order to compare the costs associated to the monitoring, reporting and verifying, with the global cost reduction derived from the new incorporation to the EU ETS. Moreover, other alternatives (taxes, command and control measures, etc) should be analyzed before incorporating new sectors and gases to the EU ETS scheme.

Regarding the incorporation of Carbon Capture and Storage (CCS) to the EU ETS, is of the view of Iberdrola that subsidies should only be granted to this technology in the demonstration phase. In further operational phases, investments in CCS, as the rest of investments should be driven by the long term price signal derived from the ETS itself. Therefore, CCS should be incorporated to the EU ETS and this scheme will signal which CCS investments are efficient in order to achieve the emission reduction targets assigned to the EU ETS sectors.

In case that, for other reasons apart from the efficiency in emissions reduction, it is decided that CCS will be provided with a subsidy in order to facilitate its large-scale deployment, this should be clearly signalled well in advance in order to avoid stranded investments. Such stranded investments will emerge when efficient investments made in order to achieve the emissions reduction target will become unnecessary because subsidized investments in inefficient technologies will replace them.

Regarding the incorporation of credits from domestic projects into the EU ETS, projects in sectors included in the EU ETS should be prevented from participating, in order to avoid double counting in the emission reductions achieved. Moreover, it should be carefully addressed how these domestic projects interact with the policies and measures put in place to achieve emission reductions when they are applied in the same sectors. This idea links with the problem of proving the additionality of these projects. All these issues should be clearly settled before any credit from these domestic projects is accepted in the EU ETS.

In addition, before accepting within the EU ETS, credits from domestic projects from one specific sector, it should always be taken into account the possibility of incorporating such a sector in the trading scheme.

Moreover, the incorporation of these credits could modify the long term price signal. Therefore, the same cautions regarding predictability and price shocks

as the ones applied to the incorporation of new sectors and gases should be applied in this case.

Linking with emissions trading schemes in third countries, and appropriate means to involve developing countries and countries in economic transition.

Linking with other emissions trading schemes is efficient, as the total cost of achieving the emissions targets will be reduced.

However, there are some technical issues that should be taken into account before the linking is finally implemented. A key issue is the developing of equivalent compliance and verification systems, i.e. rules that affects monitoring, reporting, verification and penalties.

Moreover, it should be carefully addressed how the linking with other schemes is going to affect the offer and the demand for emissions reductions, and therefore the price of CO₂. Therefore, issues regarding predictability and price shocks should be carefully taken into account when implementing any linking with other schemes.

Regarding how to involve developing countries in emissions reductions, this is currently done mainly with the CDM's: project based flexible mechanism of the Kyoto Protocol. Flexible mechanisms also let developed countries achieve their emissions commitments in a more efficient way. This improved efficiency is also translated to the EU ETS as credits obtained through CDM's and JI's are accepted within the scheme.

However, a limit should be imposed to the use of these mechanisms. This limit will provide a more stable framework for investment within the EU ETS, incentivising the very much needed investment for future emission reductions.

In the post-Kyoto framework, it is still not clear how developing countries will join the common effort of reducing CO₂ emissions. However, as it seems quite likely, if they don't finally assume a cap on their absolute emissions, reduction credits from these countries pulled into the EU ETS should be limited, so the framework for emission reduction investment is kept stable.