

EURACOAL Position Paper

on structural reform of the EU Emissions Trading Scheme (ETS) in response to the European Commission's report on the state of the European carbon market in 2012

Summary

The Commission asks stakeholders to respond on six options for structural reform of the ETS. EURACOAL summarises here its responses:

1. Increasing the EU GHG target to 30% in 2020: not permitted under the ETS directive since no new international agreement has been reached.
2. Retiring a number of allowances in Phase 3: no justification for this because agreed targets will be met with an already disproportionate burden on the ETS sectors.
3. Early revision of the annual linear reduction factor: political capital should be spent on agreeing post-2020 targets, not revisiting those already agreed for 2020.
4. Extension of the scope of the EU ETS: this should be an objective when negotiating Phase 4 since the economic efficiency of the ETS demands that it includes as many emitters as possible.
5. Limiting access to international credits: climate change is a global challenge that cannot be solved by the EU alone, so international credits are a legitimate tool to encourage emission reductions in non-EU states.
6. Discretionary price management mechanisms: would introduce the unacceptable moral hazard of further political interference.

EURACOAL observes that the Commission is placing at risk the Union's law-making process. If citizens see that a key directive can be so fundamentally changed with little real debate, then trust in the whole EU law-making process will evaporate.

We believe that the Commission should drop all current proposals and concentrate its efforts on negotiations with Member States and the major GHG-emitting countries around the world so that action in the EU is commensurate and complementary to actions taken elsewhere. Negotiations today should be focussed on Phase 4 of the EU ETS and post-2020 targets.

Introduction

Following its proposals to amend the ETS directive¹ and the ETS auctioning regulation² to “back load” the Phase 3 auctioning of EU ETS allowances,^{3,4} the Commission now proposes structural reforms to limit the number of ETS allowances in a bid to raise carbon prices and encourage investment in low-carbon technologies.⁵ In EURACOAL’s position papers dated 29 September 2012 and 10 December 2012, submitted in response to DG Climate Action’s earlier public consultations, we explain why the Commission proposals should be rejected. Here, we respond to the Commission’s report on the state of the European carbon market in 2012.

Options for structural reform of ETS

In its report, published up to a year ahead of the date scheduled in the ETS directive, the Commission outlines six options for longer-term structural measures to boost allowance prices in the EU carbon market:

1. increasing the EU greenhouse gas (GHG) reduction target to 30% in 2020;
2. retiring a number of allowances in Phase 3;
3. early revision of the annual linear reduction factor for the number of allowances issued;
4. extension of the scope of the EU ETS to other sectors;
5. limiting access to international credits; and
6. discretionary price management mechanisms.

Most of these options would imply major changes to the fundamental legal basis of the ETS. EURACOAL notes that such changes should be made only after negotiation between Member States, as occurred when the ETS was designed and agreed during the 1990s and early 2000s.

Legal aspects of EU climate policy and Option 1

In April 2002, the European Council agreed that the European Union would meet its Kyoto Protocol commitments by the joint and collective efforts of Member States.⁶ This was the starting point for a

¹ 2003/87/EC as amended by 2009/29/EC

² Commission Regulation No. 1031/2010

³ COM(2012) 416 final

⁴ Draft Commission Regulation amending Regulation (EU) No. 1031/2010 in particular to determine the volumes of greenhouse gas emission allowances to be auctioned in 2013-2020 (DG CLIMA, 12 November 2012)

⁵ Report from the Commission to the European Parliament and the Council on the state of the European carbon market in 2012, COM(2012) 652 final, 14 December 2012, Brussels

⁶ 2002/358/EC

number of policies with two key measures which were agreed as part of the EU climate and energy package of 2008:

- a strengthening of the EU Emissions Trading Scheme;¹ and
- the so-called effort-sharing decision.⁷

Under the climate and energy package's 20-20-20 targets, the 20% GHG emissions reduction target, compared with emissions in 1990, was split between ETS sectors (with a 21% reduction on 2005 emissions) and non-ETS sectors (a 10% reduction).

Any tightening of the emissions reduction target over and above 20% is subject to the conclusion of an international agreement on climate change and on an accompanying legislative procedure to amend the ETS directive and to renegotiate the effort-sharing decision.⁸ **No such international agreement has been reached; hence, the ETS directive does not permit Option 1.**

EU emission reduction targets, carbon prices and Option 2

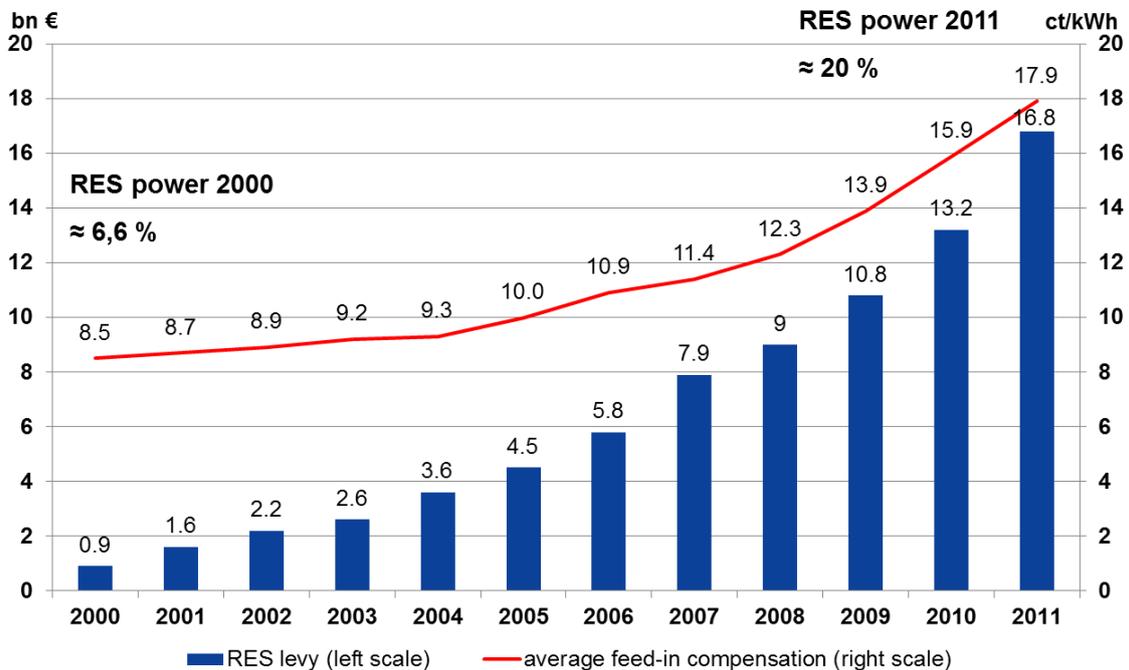
No one doubts that the EU's 20% reduction target will be met and that the EU ETS is today playing a central role in achieving these reductions. In that respect, it is an unqualified success; yet, some say that carbon prices are too low to incentivise investments in low-carbon technologies. Policy makers should ignore this complaint and bask in the scheme's cost effectiveness and economic efficiency – exactly as foreseen in Art. 1 of the ETS directive. There are two principal reasons why carbon prices are low today: the economic slowdown in the EU following the economic crisis that began in 2008; and the increase in power generation from subsidised renewables. The latter is a flaw in EU energy and climate policy: it is bad policy to use two levers to achieve a single objective – one lever will dominate. For example, in Germany the implied CO₂ price of feed-in tariffs for renewables is over €400/tCO₂.⁹ This is the price being paid to abate CO₂ emissions from a small part of the German electricity sector, leaving the consumer with a bill of almost €17 billion in 2011 as shown in Figure 1. Clearly, other parts of the electricity sector are left with a lesser burden and a lower cost per tonne of CO₂, as reflected by the low prices in the carbon market.

⁷ Decision No. 406/2009/EC of the European Parliament and of the Council of 23 April 2009 on the effort of Member States to reduce their greenhouse gas emissions to meet the Community's greenhouse gas emission reduction commitments up to 2020

⁸ See Article 8 in Decision 406/2009/EC and Article 1 and Article 28 in the Directive 2009/29/EC.

⁹ In 2011, the renewables feed-tariff was €0.179/kWh. The abated CO₂ can be assumed to be the average mass of CO₂ emitted per unit of electricity generated in Germany which was 430 gCO₂/kWh in 2009 according to IEA statistics.

Figure 1 – Subsidy per unit of electricity generated from renewable sources in Germany from 2000 to 2011 and total cost to consumers



Source: BDEW (2010)/RWI-Position #45; BMU, Juli 2012, Erneuerbare Energien in Zahlen

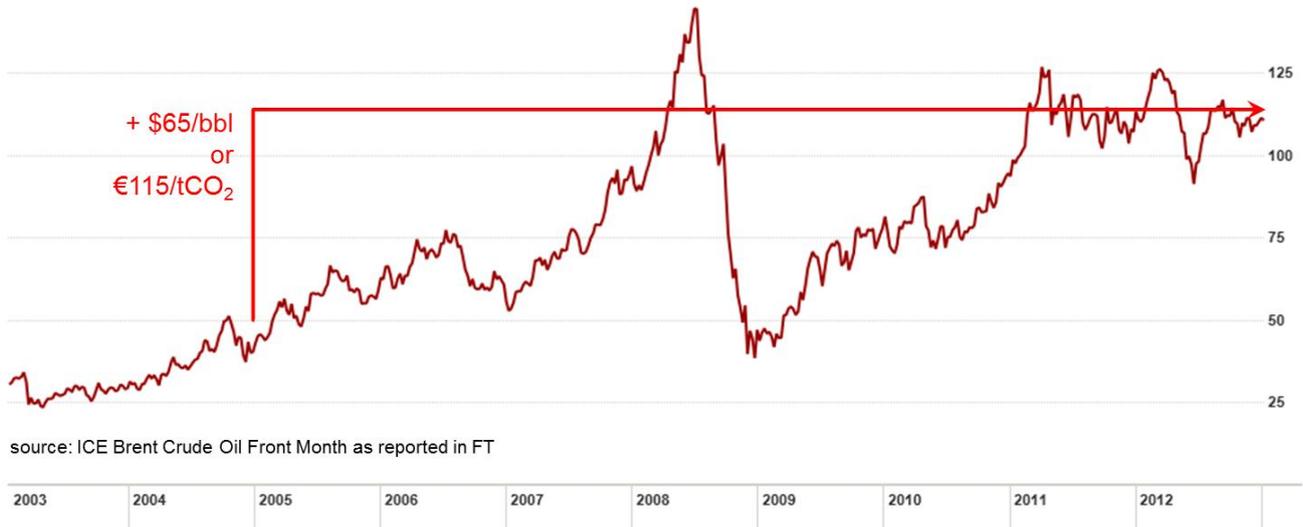
Some call for higher carbon prices to incentivise CO₂ capture and storage (CCS). This technology has yet to be demonstrated in Europe: the Commission and Member States need to push ahead with the 10-12 demonstration projects promised by the European Council in 2007. Only then can we contemplate pricing mechanisms to bring this technology into the market. It is premature to expect the ETS to deliver CCS before 2020. In fact, the only result of a higher carbon price might be fuel switching from coal to gas. With today's high gas prices and related spark-dark spreads, ETS allowance prices would need to be over €50/tCO₂ to encourage fuel switching.¹⁰ Is this the price that the Commission wants? It would push up oil prices in the EU by the equivalent of \$25-30/bbl, some 25% greater than our competitors.

More generally, today's historically high energy prices mean that energy consumers already face a rather high implied CO₂ price. Figure 2 shows that the increase in oil prices since 2005 when the ETS was launched is equivalent to a carbon price of €115/tCO₂.¹¹ Given that economic recovery depends on access to affordable energy, it is incredibly hard to understand why the Commission would jeopardise this by intervening in the ETS market to raise allowance prices.

¹⁰ Assuming a difference between the spark and dark spreads in the UK of £20/MWh in favour of coal gives €50.62/tCO₂ (gas: 49.13%, 0.411 tCO₂/MWh; coal: 38%, 0.897 tCO₂/MWh; and €1.23/£).

¹¹ \$(2005)50/bbl = €40.27/bbl, \$(2012)115/bbl = €88.71/bbl. The difference of €48.44/bbl or €355.07/toe equates to a carbon price of €424.01/tC or €115.64/tCO₂, assuming a crude oil CV of 10 000 kcal/kg and an emission factor of 20 tC/TJ (i.e. a carbon content of 83.74%).

Figure 2 – Brent crude oil prices January 2003 to January 2013 and the carbon-price equivalence of the oil price increase since 2005 when the ETS began



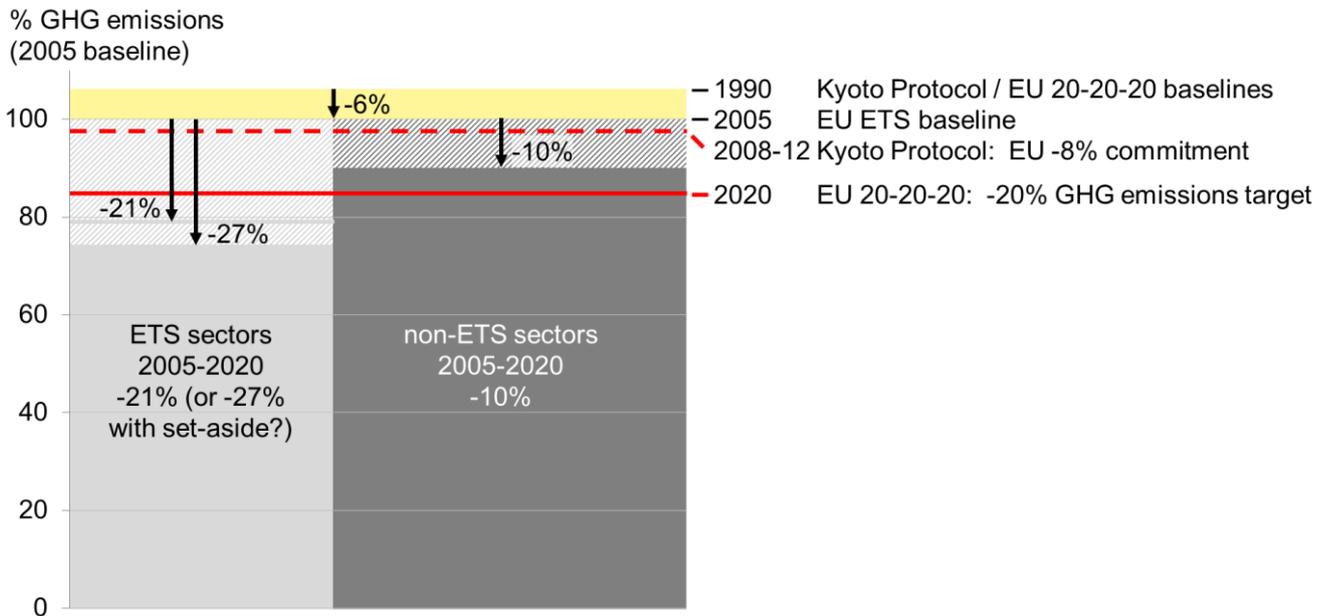
In the proportionate impact assessment accompanying its back-loading proposal,¹² the Commission concludes that the economic impacts of structural reform would be small. However, economic impacts are expressed in terms of additional costs to the industry and aviation sectors for a €1/tCO₂ increase in allowance prices. Naturally, the resulting cost increases are small percentages of, say, total electricity costs, but what about the impact of carbon price changes much greater than €1/tCO₂: €50/tCO₂ (needed for fuel switching); €100/tCO₂ (implied in today's oil price); or €400/tCO₂ (German renewables subsidy)? In its consideration of EU competitiveness, the Commission hopes that other countries will follow by implementing their Copenhagen Accord pledges and even suggests that companies with free allocations would benefit from higher ETS prices. EURACOAL remains unconvinced by this analysis and urges the Commission to revisit its rudimentary analysis of the link between EU industrial competitiveness and energy prices.

The Commission has already proposed to delay the auctioning of 900 million allowances in Phase 3 of the EU ETS by “back loading”. These allowances would correspond to about 6% of the available ETS allowances. Already, the 21% reduction imposed on the ETS sectors makes a disproportionate contribution to the 2020 target. Retiring or “setting aside” 900 million allowances would see this increase to a reduction of approximately 27% from the 2005 baseline, as illustrated in Figure 3. Compared with the Kyoto Protocol's 1990 baseline, this would be a reduction of approximately 33% – far exceeding the 8% that the EU has committed to achieve. **There is**

¹² Commission Staff Working Document [...] (2012) XXX draft, Proportionate Impact Assessment Accompanying the document Commission Regulation (EU) No .../.. of XXX amending Regulation (EU) No 1031/2010 in particular to determine the volumes of greenhouse gas emission allowances to be auctioned in 2013-2020, 12 November 2012, Brussels

therefore no justification to proceed with Option 2 and retire allowances from Phase 3 since all targets will be met, with a disproportionate contribution from the ETS sectors.

Figure 3 – GHG emissions reductions in the EU



Best use of political capital and Option 3

DG Climate Action has expended much political capital with its proposals for short-term measures to prop up the carbon market. Yet climate change is a long-term issue that calls for long-term solutions. Today’s political capital should be spent on agreeing post-2020 targets which would send a clear signal to investors through the carbon price forward curve. In EURACOAL’s opinion, it would be wise for the Commission to drop all current proposals and to concentrate on negotiations with Member States and the major GHG-emitting countries around the world so that action in the EU is commensurate and complementary to actions taken elsewhere. The ETS directive sets a linear reduction factor of 1.74% for the average annual total quantity of allowances issued by Member States. Art. 9 of the directive states that this will be reviewed sometime after 2020 with “a view to the adoption of a decision by 2025”. **Option 3 – an early revision of the annual linear reduction factor – is clearly not what Member States agreed in the ETS directive and should not be contemplated.**

An economy-wide carbon trading scheme and Option 4

As designed, the ETS covers only 42% of the EU’s CO₂ emissions. This has always been one of the scheme’s greatest limitations since it is possible that emission reductions could be made more cheaply in non-ETS sectors. This is of great concern, especially to industry, since international competitors do not face similar cost burdens. It would certainly be an improvement if the burden was spread more evenly across all sectors so that the ETS could seek out the most cost-efficient

emission reductions. **Option 4 therefore has attractions and when negotiations begin on Phase 4 of the ETS, an extension of the scheme should certainly be considered.**

Climate change: a global challenge that demands a global solution and Option 5

The EU wishes to show leadership in the fight against climate change and it has implemented some of the toughest climate policies found anywhere in the world. However, the EU accounts for just 13% of global GHG emissions and acting alone it has little impact on global emissions. The EU's leadership role must therefore encourage action in other countries: solutions in the EU must have global relevance. Part of that equation is the flexibility mechanisms that the EU negotiated and agreed along with other signatories to the Kyoto Protocol. It confounds logic for the EU to now say that it wishes to limit access to international credits.¹³ Surely the EU should remain part of any global agreements to fight climate change and honour those agreements? If the Commission has concerns about the validity of international credits, then it should address this during international negotiations. It would send entirely the wrong message if the EU unilaterally limits access to international credits: each abated tonne of CO₂ (equivalent) is equal – greenhouse gases do not observe geographic boundaries. **Option 5 would send a signal to the rest of the world that the EU does not trust international agreements and wishes to unilaterally pursue a low-carbon goal that would do little to address the critical challenge of global climate change.**

Political interference, moral hazard and Option 6

The Commission has promised that its proposed intervention in the carbon market – the back loading of allowance auctioning – would be a one-off intervention made under “exceptional circumstances”. It is impossible to predict if and when new “exceptional circumstances” would arise, but the Commission could be tempted to interfere again and destroy all confidence in the ETS as a market-based instrument. Already, there is a risk that the Commission has irreparably damaged trust in the scheme. Once traders see that votes in the European Parliament have more influence on carbon prices than genuine supply-demand dynamics (*e.g.* ETS prices fell by 40% after an ITRE committee vote on 24 January 2013), then they will view the scheme as an administrative and political tool, not a market instrument. A carbon price floor for auctions or an allowance reserve to deposit/release allowances for carbon price management would move policy away from a market-based mechanism towards a carbon tax which is not what Member States agreed when the ETS was established. **Option 6 – discretionary price management mechanisms – clearly falls into this moral hazard trap and cannot be seriously considered as a viable way to “manage” any market.**

27 February 2013

¹³ In December 2012, the Commission proposed a ban on emission reduction units (ERUs) from JI projects in countries which have not signed up to a second Kyoto commitment period.