



**EWEA**

THE EUROPEAN WIND ENERGY ASSOCIATION

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## EWEA Answer to the EC consultation on structural measures

### Urgent need for structural reduction of supply in the EU ETS

The current and forecasted low carbon price to 2020 is failing to drive investments in new renewable power capacity, risking a high-carbon lock-in in the EU. It is the consequence of a severe surplus of EU Allowances (EUAs) on the carbon market. The continuation of the economic crisis, and an unambitious and scientifically insufficient cap, means that this EUA surplus is likely to be significantly higher than the 2bn currently foreseen by the European Commission for the end of 2013.

While backloading can and needs to provide short-term relief, supply must be permanently reduced through structural measures to re-establish scarcity. EWEA favours the following three structural solutions among the ones proposed by the Commission, as they have the best potential to deliver a timely supply reduction:

- Retiring a sufficient number of EUAs in phase 3;
- Revising & increasing of the annual linear reduction factor;
- Increasing the EU domestic greenhouse gas reduction to 30% in 2020.

EWEA therefore recommends that discussions focus on these three options and urges the European Commission:

- in 2013 to retire an amount of allowances close to the estimated EUA surplus;
- in 2013/2014 to publish a 2030 climate and energy package based on 2030 renewable energy, GHG reduction, and energy efficiency targets to provide a structurally sound Emissions Trading System which would include an increase in the EU domestic greenhouse gas reduction to 30% by 2020, and an increase of the annual linear reduction factor to meet a suitably ambitious 2030 GHG target.

#### I. Structural measures must permanently reduce supply before 2020

Confidence in the ETS has been fundamentally undermined and it neither drives new investments, nor plant operation today. Backloading is a necessary first step, but will only delay and not solve the structural problem of oversupply in the ETS. A permanent solution must be agreed to adjust supply to the lower demand resulting from the economic downturn and re-establish scarcity on the market. Without such a permanent reduction of supply, market actors will anticipate the re-introduction of the backlog and the carbon price will not recover.

##### **Structural measures must reduce supply throughout phase 3 (2013-2020)**

Only options having an impact on supply before 2020 should be considered. Firstly, only action before 2020 will avoid backloaded EUAs returning to market and causing a price crash. Secondly, with a 2bn

EUA surplus – worth one year of ETS emissions – a post-2020 adjustment will not start reducing the surplus significantly and increase prices before later that decade (2025-2027). The result would be a carbon price that has no impact on investment decisions for a further 15 years, resulting in a fossil fuel lock-in. Thirdly, following this lock-in, a needed significant increase in climate ambition will be much harder to achieve than if the signal is given today – delayed investments are costlier.

#### **Valid structural solutions: move to 30%; increase of linear factor; or retire EUAs**

- EWEA has long advocated a move to 30% domestic reductions by 2020 as a solution to the climate, energy and economic crisis, while ensuring that EU policy complies with the 25-40% domestic reductions needed in the industrialised nations to keep global warming below 2°C.
- Action to increase the linear factor limits legislative action to ETS sectors only, which is a second-best option as this is where the main issue lies.
- Reducing the amount of EUAs to be auctioned further limits impacts to mostly the power sector, leaving heavy industry unaffected by the changes in supply. While this solution does not have the positive long-term effect of the previous two, it has the advantage of speed and could be implemented fairly quickly. It should hence be implemented immediately following backloading thereby giving time to agree on a more structural solution.

#### **A 2030 climate and energy package can reduce the EUA surplus, if it reduces supply before 2020**

An ambitious target for renewable energy, together with ambitious targets for GHG emission reductions and energy efficiency, should be the cornerstone of a 2030 climate and energy package. However, the ETS cap and renewable targets should be set at a coordinated level and aligned, as was the case for the 2020 targets, in order to work in a coherent and concerted way, underpinning and mutually supportive.

Agreeing to an ambitious GHG reduction target could increase demand and reduce the EUA surplus. Current estimates<sup>1</sup> show that without additional action, the ETS surplus could remain until 2030. But even with an additional post-2020 reduction, e.g. through a lower cap, the surplus will not be soaked-up before well into the next decade (2025-2027). To provide an effective investment driver, any decision on a GHG target for 2030 must therefore:

1. Be part of a package including an ambitious 2030 target for renewable energy continuing to drive investments in a broad range of renewable energy technologies post-2020;
2. Reduce supply faster than current legislation provides for;
3. Include a re-alignment of the 2020 target to match the new 2030 target (cap reduction), hence reducing supply before 2020.

**EWEA therefore recommends that discussions focus on these three options, as they have the best potential to deliver a timely supply reduction, and urges the European Commission:**

- in 2013, to retire an amount of allowances close to the estimated EUA surplus
- in 2013/2014, to publish a 2030 climate and energy package based on 2030 renewable energy, GHG reduction, and energy efficiency targets to provide a structurally sound Emissions Trading System which would include an increase in the EU domestic greenhouse gas reduction to 30% by 2020, and an increase of the annual linear reduction factor to meet a suitably ambitious 2030 GHG target.

#### **Extension of the scope of the ETS to new sectors risks further undermining the system**

Ideally, all GHG emissions should be covered by the system, to avoid unintended arbitrage and consequences. However, adding new sectors in the ETS through a cap increase (i.e. additional allowances) is risky and should be avoided in the short term: ETS history tells us that new sectors tend to be over-allocated when first cap estimates are made and this risks further increasing the EUA

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<sup>1</sup> EC Staff Working Document on the functioning of the EU ETS from 25<sup>th</sup> July 2012

surplus rather than reducing it. Including new sectors without increasing the cap would lower the surplus. However, this would not be without opposition and would add complexity to the system. New sectors are in theory a welcomed inclusion, but only into a system that already delivers incentives, which is not presently the case.

#### **Price floors and automatic downward adjustments can provide investment certainty**

Before implementation of the ETS, EWEA advocated for a carbon tax as the most stable, transparent economically efficient and effective way to provide investment signals. A price floor would be a welcome addition to the currently ineffective system, preventing disappearance of investment signals in times of oversupply, while still incentivising emission reducing investments – generating surplus EUAs for the investor to sell. Similarly, an automatic downward adjustment of the cap is welcome and could be e.g. triggered by a specific price.

As a general rule, however, ceiling prices and automatic upward cap adjustment, should be avoided, as they go against the idea of a limit on emissions. To reach the Heads of State commitment to reduce emissions by 80-95%, the power sector needs to be completely decarbonised by 2050. This means an ambitious and regularly decreasing limit to absolute emissions, from today onwards. Price spikes merely reflect a lack of emission reducing investment, which are not a valid reason for intervention.

## **II. The negative impacts of a low carbon price**

### **Low carbon prices have negative impacts on technological development**

The low CO<sub>2</sub> price provides no incentive for investment in wind power, a key solution to CO<sub>2</sub> power sector emissions. The EC's 2050 Energy Roadmap shows that wind energy will be the leading energy technology in 2050 in all decarbonisation scenarios, producing between 31.6% and 48.7% of electricity. But the current CO<sub>2</sub> price does not provide a level-playing field for new-build investment decisions between fossil fuels and wind power, or other renewables. In short, the ETS has no impact on investment decisions in the power sector, because investors believe the low carbon price will persist.

Reaching the agreed 80-95% emission reductions in 2050 requires a zero-carbon power sector by 2050, which in turn, requires full integration of CO<sub>2</sub> costs via a well-calibrated ETS cap. Moreover, due to the long lifetime of power production assets, 2050 is only one investment cycle away and the transition must begin now if the 80-95% objective is to be met, as early action will be cheaper in the long-term.

### **Low carbon prices have negative impacts on growth and the EU's trade balance**

It should be a European objective to replace fossil fuel imports with renewable energy technology exports. Despite the current recession, the European wind power sector exported €8.8bn worth of goods and services in 2010<sup>2</sup>, while the EU's trade balance was €-150bn. This underlines that exporting industries greatly help the EU's trade balance and overall economic situation. The EU currently has a clear technological advantage in wind energy, and a strong carbon price should provide a strong political signal to investors to innovate and maintain this advantage.

## **III. With or without backloading, close to 2bn EUAs must be retired prior to a 2030 package, as the surplus will likely exceed 2bn**

According to the EC's Staff Working Document<sup>3</sup>, the current auctioning schedule would see the 1.7bn EUA oversupply in 2012 increase further to about 2bn in 2013 and 2 - 2.3bn by 2020 or more. The action proposed by the EC – delaying the auctioning of 900M EUAs – would leave the system oversupplied by at least 1.2bn until 2020. While some buying patterns (e.g. hedging by the power sector) require some kind of liquidity, EWEA sees no justifiable reason to leave such a large surplus for so many years. Additionally we consider that there is a strong probability that these figures underestimate oversupply.

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<sup>2</sup> EWEA 2012. Green Growth.

The continuation of the economic downturn is the main factor leading EWEA to believe that oversupply will be larger than currently expected though other factors will have an impact as well:

**The economic downturn created oversupply** throughout 2008-2012 in the ETS. For 2013-2020, the Commission's chosen emission pathway to 2020<sup>3</sup> accounts for the 2009 economic downturn, but not for the "double-dip" recession we are currently experiencing. The resulting lower emissions are not reductions as such, but will continue to be below the cap and to generate a significant surplus beyond what is currently modelled. This could easily amount to several 100Mt additional surplus in the coming years. Additionally, the cap set for the period 2008-2012 for heavy industry players was already generous, and would have resulted in over-allocations even in the absence of economic downturn.

**The Commission's scenario<sup>3</sup> excludes the impact of the Energy Efficiency Directive** on emissions. It foresees a level of projected emissions by 2020 somewhere between the "baseline" and "reference" scenarios<sup>4</sup>. This means the EC assumes that the climate package will not be implemented, which was partly justified until very recently, as the Energy Efficiency target was unlikely to be met. With the agreement on the Energy Efficiency Directive, more abatement is likely to come than foreseen in that scenario. More information on the CO<sub>2</sub> impact of the EED is needed but this is likely to further reduce emissions and increase the currently estimated surplus.

**For 2012, CER use is assumed to be the same as in 2011** (252Mt). But CER use is likely to increase before April 2013, e.g. as companies will try to surrender as many HFC-generated credits as possible before the ban. This means the amount to consider for retirement before a 2030 package should be higher as well. However, this does not affect the cumulative oversupply by 2020 and hence the amount to consider in further structural measures<sup>5</sup>.

For these combined reasons, we consider the 2bn figure for oversupply to be an underestimation, both for retirement of EUAs and for ulterior structural measures.

#### **Other factors could reduce oversupply, but are either unlikely or unwanted**

**Additional investments in emission reductions from heavy industry.** These are rather unlikely for now, as the roughly 900M EUA surplus that accrued to these sectors between 2008-2012 will help them cover all emissions beyond their allocated benchmarks.

**A fast economic recovery** is similarly rather unlikely.

**The current low prices for coal favours burning coal over gas to generate fossil-based electricity,** increasing power sector emissions since early 2012 already. This is likely to last in the foreseeable future and will hence have a downward effect on oversupply. However, while the other factors are independent from the ETS system this is clearly a negative short-term consequence of the low carbon price, rather than a solution to oversupply. As such, this effect should be factored out when considering an oversupply figure for either backloading or structural measures given that those will reduce it permanently.

**While wind energy and other renewables** significantly reduced emissions in the last years, cap setting in the 2008 ETS Impact Assessment assumed that the 20% renewable energy targets would be met. As such, only overshooting our renewable energy target would result in renewables affecting oversupply by 2020. Current EU-wide renewable energy deployment is following the 2008

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<sup>3</sup> EC Staff Working Document on the functioning of the EU ETS from 25<sup>th</sup> July - Figure 6 p 20. The EC presented this scenario as a likely one and we base our estimates on it.

<sup>4</sup> Both scenarios from the EC's 2010 "Low Carbon Roadmap 2050"

<sup>5</sup> While structural measures must look at cumulative surplus over the entire period, the backloading aiming at propping up the price of carbon must look at oversupply at a given time on the market. As such, how many of the maximum 1.7bn CDM credits is used each year matters for backloading, whereas only the maximum amount must be considered for structural measures.

assumptions<sup>6</sup>. This means that renewable energies are not and will not be undermining the 2020 cap or overlapping with the ETS, as is on occasion put forward.

In conclusion, oversupply is unlikely to be reduced, or will do so allowing for more coal emissions and a high carbon lock in. This confirms EWEA's previous analysis that a higher figure than the currently estimated 2bn needs to be considered for retirement, prior to a 2030 package.

### **Agreeing on structural measures requires new modelling to 2020**

As discussed above, the economic outlook is a major source of uncertainty as to how much cumulative surplus will remain in the system 2020-2030. Today's projections for ETS emissions to 2020 are significantly lower than in the 2010 scenarios as confirmed by several carbon analysts<sup>7</sup>. The modelling done in the EC's 2010 "Low Carbon Roadmap 2050" used for the backloading Impact assessment needs updating to reflect present economic conditions. Given the current trends, re-assessing the surplus by 2020 is likely to yield a figure well above 2bn.

**In conclusion, reducing supply by close to 2bn EUAs should increase prices and resolve oversupply, while still enabling power sector hedging. Whether backloading happens or not, EWEA recommends retiring a number of EUAs as close as possible to the currently estimated oversupply (i.e. 2bn) in 2013. Following this, in 2013/2014, to publish a 2030 climate and energy package based on 2030 renewable energy, GHG reduction, and energy efficiency targets to provide a structurally sound Emissions Trading System, which would include an increase in the EU domestic greenhouse gas reduction to 30% by 2020, and an increase of the annual linear reduction factor to meet a suitably ambitious 2030 GHG target. Such an approach would continue to drive investments in a broad range of renewable energy technologies, including onshore and offshore wind, resulting in lower costs in the long-term than an ETS-only approach.**

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<sup>6</sup> As presented in document SEC(2008) 85 from 23/01/2008 - Impact Assessment on the package of Implementation measures for the EU's objectives on climate change and renewable energy for 2020

<sup>7</sup> Deutsche Bank, Point Carbon, Bloomberg New Energy Finance among others