

Royal Dutch Shell Plc
30 Carel Van Bylandtlaan
The Hague 2596 HR, Netherlands
EU Register of Interest Representatives' ID: 69545381134-55

European Commission
Directorate General for Climate Action
Head of Unit B1,
28 February 2013

RE: DG Climate Action consultation on the report from the Commission to the European Parliament and the Council – The state of the European carbon market in 2012.

Dear Ms. Slingenberg,

Shell welcomes the opportunity to respond to this consultation from DG CLIMA. We have set out our views regarding the key issues for your consideration.

Summary

Shell supports a strong and well-functioning EU Emissions Trading Scheme (ETS) as the central pillar of the EU climate and energy policy. We believe that the EU ETS provides the lowest cost route to decarbonise the power and industrial sectors, while incentivising investments in low carbon technologies and protecting industry from carbon leakage. The credibility of the EU ETS is vital, and a strengthened EU ETS would continue to encourage other jurisdictions outside of Europe to introduce compatible schemes.

We believe that a clear energy and climate framework for 2030, including an economy-wide greenhouse gas (GHG) emissions reduction target compatible with Europe's 2050 decarbonisation aspirations is essential. We support measures to strengthen the EU ETS and restore the original level of ambition which has been undermined by unforeseen macro-economic events. Our preferred option is a retirement of allowances and, longer term, the introduction of an auction reserve price.

The design of the EU energy and climate policy to 2030 is key to set up a clear, stable and longer term framework that guides investment along the transition towards a lower carbon energy system. Shell supports a swift agreement on an overarching GHG reduction target to 2030. Against this framework, the Commission should consider an adjustment to the linear reduction factor adequate to deliver the robust carbon price required to meet the objective of the EU ETS.

The EU ETS provides vital funding for the demonstration of new and emerging low carbon technologies through the NER 300 mechanism. We believe the NER 300, currently due to expire in 2015, should be turned into a permanent funding mechanism, that supports the development of the low carbon technologies that will be required to meet the ambitious EU decarbonisation objectives. The demonstration of emerging low carbon technologies is key to reduce costs over time, and build public confidence. Eventually, such technologies will become commercial and will be deployed cost-effectively thus supporting the transformation to a low carbon economy. As is the case with the current NER 300, the new EU demonstration fund should be time-limited, and deliver funds against verified performance in the context of a competitive bidding process.

Background

Shell is one of the largest independent oil and gas companies in terms of market capitalisation, operating cash flow and oil and gas production. Europe is a key region for Shell where we continue to explore for, produce and refine oil and gas into the building block of many everyday consumer products. Shell is an energy intensive company exposed to international competition and we support the mechanism established in the ETS Directive to protect exposed industries. At the same time, we are a key actor in developing low emission technologies, such as renewable fuel technologies and carbon capture and storage (CCS).

General Approach

As recognised by the IEA¹, carbon pricing is the key element of a least cost response to reduce emissions, and an emissions trading scheme is an effective policy mechanism to introduce a carbon price. Shell supports the EU ETS as the flagship instrument, within the EU energy and climate policy framework, for delivering emission reductions at lowest cost in the power and industrial sectors, providing the necessary price signal for the development of low-emissions technology, and providing measures to support the competitiveness of energy intensive and trade exposed sectors.

Furthermore, the EU ETS is intended to play a role to advance technologies that will enable emissions reductions² whilst maintaining economic. The auctioning of 300 million allowances from the New Entrant Reserve (NER 300) will help deliver the ambition of Europe's technology demonstration programme.

Options Outlined in the Carbon Market Report:

Outlined below are Shell's views on the options outlined in the carbon market report.

Shell supports option b "retiring a number of allowances in phase 3" as the most effective policy route to restore the well-functioning of the EU ETS. We believe that the underlying purpose of an ETS is not

¹ (C. Hood 2011). Summing up the parts: Combining Policy Instruments for Least-Cost Climate Mitigation Strategies, IEA information paper

² as described in the staff working document, accompanying document to the proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the EU greenhouse gas emission allowance trading system, Impact Assessment which states an objective of the EU ETS is "Contributing to transforming Europe into a low greenhouse-gas-emitting economy and creating the right incentives for forward looking low carbon investment decisions by reinforcing a clear, undistorted and long-term carbon price signal"

simply to meet a GHG emissions reduction target, but to impose a certain level of ambition on the covered sectors to catalyse the transformation to a low-emission economy. If the covered sectors undergo a macro-level change, so too should the ETS to ensure that this level of ambition is maintained. Otherwise, there is no immediate incentive for any underlying environmental improvement because demand reduction hits the system and the need to reduce emissions is delayed.

We support retiring allowances in phase 3 to remove the current surplus generated from the previous trading phase due to the economic recession and the overlap of policies. In our view this option is akin to a baseline recalibration due to the unforeseen macro economic events and would allow the EU ETS to regain credibility and become the primary driver to reduce emissions from the power and industrial sectors.

In the absence of a strong carbon price signal, via the EU ETS, a patchwork of Member State policies to incentivise low carbon technologies is likely to emerge. This will add further cost and complexity to industry. Retiring a number of allowances in phase 3 will not impact the level of free allocation before 2020 so it represents a route to strengthen the scheme, while ensuring the protection of energy intensive industries exposed to the risk of carbon leakage.

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

Increasing the EU reduction target to 30% in 2020 could result in a requirement to renegotiate the Effort Sharing Decision (ESD) and furthermore would require reopening a number of Directives in the 2008 Energy and Climate Package to deliver the new goals within a very short timeframe. Instead, Shell supports the adoption of a swift political decision on an overarching GHG reduction target for 2030. This would also trigger a strengthening of the ETS, while establishing a longer term pathway to deliver the investments required to meet the new levels of ambition. Shell urges policy makers to consider options which minimise any changes to agreements under the climate and energy package and, while we believe there is a case for structural reforms to strengthen the carbon price, we consider this could be better achieved by retiring allowances between 2013 and 2020 (option b). We ask for governments to set targets and the frameworks under which to achieve their climate change goals giving clarity to industry on its role within the framework.

We believe that the targets should be changed after 2020 in order to meet the longer term 2050 goal. This gives business the certainty that the EU ETS will be a central pillar in the longer term, whilst minimising the impact on the current framework, such as the level of free allocation to industries deemed at risk of carbon leakage.

Option c - Early revision of the linear reduction factor (LRF)

The LRF decreases the cap by approximately 37 million tonnes of CO_{2e} every year, which roughly equates to a 35% reduction by 2030, and a 70% reduction in GHG emissions in 2050, compared to 1990. The EU ETS Directive currently includes a review of the LRF in 2020 with a decision to change the LRF by 2025. If the EU agrees to an economy-wide 2030 GHG emission reduction target with a strong EU ETS as the

central pillar to achieving such reductions, then the LRF could be revised earlier and act as a mechanism to reduce the surplus of allowances.

Option d – Extension of the scope of ETS to other sectors

In principle, Shell supports a wide coverage for ETS. However, while a single, economy-wide carbon price is theoretically the most efficient approach to achieving a low emissions economy, this solution is unlikely to catalyse the early technological change and initial deployment of technology required in every sector. This is because the price response varies from sector to sector due to differences in behaviour, infrastructure turnover rates, and the utility value of existing assets. In some sectors, a relatively low carbon price would stimulate immediate changes, but in others the costs would remain too high, meaning that changes might not occur and advanced technologies would not be developed within the desired timeframe. This is particularly the case for the road transport sector. Reducing CO₂ emissions in road transport requires an integrated approach, involving changes in vehicles, fuels and infrastructure, as well as measures to influence driver behaviour. Shell recognises the objective of the EU to drive change in the transport sector in parallel to decarbonisation in the industrial and power sector. In our view the inclusion of transport in the ETS would be insufficient to achieve this objective.

Furthermore, we believe that for a sector to be included in an ETS, it must fit into the system of the "make-or-buy" model, i.e. that the holder of the allowances has both the ability to make reductions through specific projects to meet compliance, or can buy allowances to meet compliance. We believe that the road transport sector does not correlate to this model because no single obligated party could deliver results without cooperation from others including fuel suppliers, transport planners, vehicle manufacturers and users. Hence, we do not support a change to the scope of the EU ETS.

Option e -Use access to international credits

As mentioned previously, the cost effectiveness of reducing GHG emissions through a carbon market is primarily determined by the range of abatement options available to the market. International linkages provide for a deeper and more liquid market by increasing the availability of more cost effective abatement options.

International linkages between emissions trading schemes will drive down the cost of compliance; Fungible linkages open access to cost-effective international abatement options. Those linkages will reduce the cost to the economy as a whole without compromising the emissions reductions ambitions.

Shell is supportive of further efforts to create international linkages and cost – effective offsets provided that only certified and otherwise regulated international credits should be allowed to enter a compliance-based ETS; and the objective of the offset should match the objective of the related trading system, for example the EU ETS offsets should originate from power sector decarbonisation projects. Although our preferred option for structural reform in phase 3 is to retire allowances, overall Shell is neutral to any future restrictions on international credits as long as changes are implemented in a transparent manner and with the appropriate lead time.

Option f – Discretionary price management

With limited experience of operating trading schemes, it was difficult to foresee that predicting emissions would be so challenging. There is a body of literature that argues in favour of combining certain features of both price-based and quantity-based instruments, to create “integrated” policies. A recent example³, from Fankhauser and other authors, concluded that trading schemes with price-like features, such as a reserve price below which allowances are not auctioned, should be considered to support carbon prices.

In terms of discretionary price management, our preference is for an auction reserve price which could give a long-term carbon price signal and provide companies some certainty over the return on investment in abatement technologies. Furthermore, it would also reduce the likelihood that EU Member States act unilaterally. Shell supports the introduction of an auction reserve price to ensure that allowances are only released onto the market if the auction reserve price is met. This mechanism would also help to reduce the risk of investing in low carbon technologies which will enable Europe to meet their longer term decarbonisation targets.

Three other options which are not currently considered in the Commission report but which are widely commented on and/or used elsewhere include:

(i) Dynamic / Ex-post allocation

The EU ETS is based on ex-ante allocation i.e. allowances allocated before participants need to surrender them for compliance purposes. An ex-post allocation system could incentivise industry to reduce emissions as the allocation of free allowances would be based on the most energy efficient processes, and the quantity of free allowances would be linked to output and therefore economic conditions.

Ex-post allocation could complicate the system by requiring retrospective adjustments to allocations. It would mean that the industrial sector would not have any allowances at the start of a compliance period and would not be able to raise capital through the carbon market for energy efficiency investments. Shell does not support dynamic or ex-post allocation as it would add additional compliance costs and burdens. We believe that allowances should be distributed (either through auctioning or free allocation) early in any compliance year and placed in registries so that a participant has access to the value of their allowances. This encourages the secondary market and particularly the involvement of smaller entities that may be unwilling to enter into trade without physical allowances available to them.

(ii) Rolling cap

We observe in the case of the EU ETS that predicting economic growth is difficult so we could consider a more flexible cap setting process which would reduce the long term certainty but remove the need for ad-hoc adjustments in the event of unforeseen circumstances. However, an annual process could be overly burdensome and further analysis of this option is required. The current EU ETS has a long term

³ Fankhauser, Samuel and Hepburn, Cameron and Park, Jisung (2010). Combining multiple climate policy instruments: how not to do it. *Climate Change Economics* 1 (33), pp. 209-225. ISSN 2010-0078

trajectory which can be amended and the long-term trajectory is important to give investors in carbon abatement the long term certainty that is required.

Demonstration funding for CCS and innovative renewable energies

A much lower than expected CO₂ price has substantially reduced the value of the revenues for demonstration created by the NER 300. This undermines the EU's ambition to demonstrate emerging technologies. Furthermore, the current NER 300 funding programme will cease by 2015, or once the second round of funding is complete. Such innovative low carbon technologies are urgently required to meet the decarbonisation objectives for 2030 and beyond, and strengthen the potential competitiveness of European technology. Shell supports converting the NER 300 into a permanent demonstration funding mechanism aligned with the overall ambition of the EU ETS which seeks to enable low carbon and renewable technologies to become competitive.

This will help close the gap between R&D and the market deployment of emerging energy technologies, allowing Europe to compete for investments with other regions of the world and supporting Europe's agenda for sustainable growth.

Conclusion

Beyond the climate change goals, we believe the objective of the EU ETS is to catalyse the transition to a low carbon future by incentivising investments in low carbon technologies. Today's surplus of allowances and the resulting low carbon price fails to deliver the necessary price signal. We believe that a permanent retiring of a number of allowances, combined, longer term, with a carbon floor price and a clear 2030 policy framework is the best way to restore the original level of ambition of the EU ETS and ensure it remains at the heart of the EU Climate and Energy Policy.

Yours sincerely,



Ivan Martin,
Head EU Liaison
Shell International