



PROPOSAL FOR A CEPS TASK FORCE ON

**DOES THE REVISED EU ETS MARKET PRODUCE THE
'RIGHT' PRICE SIGNAL?**

Chair: **Henry Derwent**, CEO & President, International Emissions Trading Association (IETA)

Rapporteurs: **Christian Egenhofer**, Senior Research Fellow, CEPS

First meeting: 28 October 2011 (from 10:30-16:30)

Second meeting: November/December 2011

Third meeting: January/February 2012

Meeting venue:

Centre for European Policy Studies (CEPS)

Place du Congrès 1, 1000 Brussels

For regularly updated information about this CEPS Task Force, please visit:

www.ceps.be/panel4

1. Introduction

According to the EU ETS Directive (Art. 1), the objective of the ETS is to “promote GHG reductions in a cost-effective and economically efficient manner”. Hence, the over-arching objective is cost-effective achievement of a politically given target. By some, including most conventional economists this is construed as a call for the lowest possible EU allowance price, for example allowing the use of as many offsets as possible – provided they reflect real reductions to reach a given objective. While this might be a valid argument in the short-term, for example to reach the 2020 targets, it masks the fact that over the long-term – 2050 and beyond – an efficient climate change policy will need to accelerate the development and diffusion of new and breakthrough technologies. If this does not happen, the EU risks being locked-in into high-carbon technologies, which, once carbon carries a higher price could lead to its industry becoming uncompetitive. This is so if industry does not believe that EUA prices will increase.

This points to a fundamental debate within the EU and elsewhere; what exactly is the role of the ETS is, whether it is to drive the transformation towards the low-carbon economy¹ and, what role does the EU allowance (EUA) price play? One should not forget that the price signal is essential but most likely on its own it will not suffice. Another question then is whether the ETS following the substantial revisions agreed in 2008 creates a ‘proper’ price signal. If not, would there be tools to help generating a ‘more appropriate’ signal.

2. The EU ETS carbon price debate

¹ The proposal to amend the ETS Directive had identified three major objectives: 1) “Fully exploiting the potential of the EU ETS to contribute to the EU’s overall GHG reduction commitments in an economically efficient manner”; 2) “Refining and improving the EU ETS in the light of experience gathered”, and 3) “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” (European Commission 2008: p. 3).

To date it is uncertain when the EUA price will be able to ensure arbitrage of different fuels on the basis of carbon prices instead of commodity price, thereby affect operational (i.e. which plants to run and for how many hours) as well as long-term investment decisions.

There is also uncertainty to what extent the large-scale auctioning that will come in 2012 will affect inefficient old coal plants that to date have still benefitted from free allowances.

True, the limits of the price signal emanating from the ETS – especially before a truly international carbon market takes shape – are nothing new and have been recognised – implicitly – by the EU before. This has been so for example by establishing a separate policy for renewables and to a lesser extent for Carbon Capture and Storage (CCS) and the concept of the Strategic Energy Technology (SET) Plan.²

New is however the effects of the economic crisis, which is widely acknowledged to depress the EUA prices for years beyond the end of the crisis due to rapid and dramatic changes in economic output and the resulting surplus of allowances, which can be carried over into phase 3 and beyond. Few expect EUA prices to climb much higher than €25 or €30 throughout the period up to 2020. But this would also mean that the original objective is being achieved with a low price, which for some is ‘the’ problem.

As a result, there is a – sometimes confusing – political debate on the ‘right’ ETS EUA price, a possible lack of a price signal and potential measures to address this apparent problem. Especially supply side measures are increasingly part of the debate around effectiveness of the EU ETS, notably the risk that oversupply could hamper the carbon price signal. An important question is whether or not scarcity is still ensured in the market and will be over phase 3. Supply side measures could either remove or add supply to the market and could consist in setting aside (or releasing) a certain number of allowances from the yearly auction volume, introducing a price floor (and possibly ceiling), more active price

² See, Nuñez-Ferrer, J, C Egenhofer & M Alessi, *The SET-Plan: From concept to successful implementation*, CEPS Task Force Report, April 2011

management and oversight through a central independent institution (carbon bank proposal) etc.

3. Recent developments

Against the background of the effects of economic crisis, the European Commission has proposed a so-called set-aside, the idea being to withhold a certain number of EUAs either temporarily or permanently, following amending legislation, i.e. to increase scarcity. It is likely that such a move has been motivated by the fact that politically in the EU a move to increase the ambition of the current 20% GHG reduction target in the foreseeable future is very unlikely.

Some argue that the set-aside proposed by the European Commission is not the only attempt by the Commission to 'influence' scarcity and therefore the price. Other proposed and implemented measures such as delaying the selling of the 300 million allowances which have been earmarked for the NER300 or restricting the use of CDM credits stemming from industrial gases or possibly other sources are seen by some as motivated by the same rationale. The European Commission argues that such regulatory decisions are not made for reasons of 'influencing' prices and e.g. the restrictions on CDM credits are made out of concerns of environmental 'integrity', and as a strategic lever to further the EU's CDM reform demand and transition to sectoral crediting. Still many market participants insist that the Commission is acting to reduce supply.

Some Member states are concerned about low EUA prices and have recently started to design policies such as for example the UK carbon price support mechanisms, in essence a price floor for the UK only.

The proposed European Commission Energy Efficiency Directive foresees efficiency standards also for the ETS sector. While this would subject industry to standards, it would also reduce the EUA price as a result of the mitigation that would happen under the proposed Directive. The big question is why is this thought to be necessary if a carbon price increases the cost of failing to address energy efficiency.

The market, however, seems to have little appreciation of this plethora of measures. At around the time that various measures have been discussed EUA prices have fallen. Some argue that the envisaged measures have contributed to an erosion of confidence in the market. But one should not forget that this is mostly due to the overall economic crisis.

4. What will achieve the 'right' carbon price?

Ultimately, the EU ETS will only prove effective if it influences operational and long-term investment decisions so as to transform the capital stock to allow the EU to meet its short and long-term targets in a cost-effective way.

There is a discussion that the signal stemming from EUA prices might not be able to achieve this. Some therefore speak of a 'wrong' price signal (without however defining what 'wrong' means.)

Still, mainly but not only with the fall of the EUA prices induced by the economic crisis, a considerable number of measures have been proposed to address 'real' or 'perceived' shortcomings of EU ETS price signal. Many remain controversial because they raise questions regarding effectiveness to influence operational and investment decisions. Measures will also need to surmount significant potential institutional, legal, financial or political barriers. One should not forget that there is an open question to what extent governments are able to convince business and investors that following 'their' price signal is politically less risky than ignoring it.

This CEPS Task Force attempts to take stock and examine these issues in greater depth. More concretely, it will attempt to identify the key questions that arise from current EUA prices, and the market response to them, notably separating 'real' from 'perceived' problems. It will identify the potentially most suitable measures/strategies to address the identified problem. Finally, it will examine practical ways of implementing measures, i.e. think through the implications of implementing the different potential measures.

5. A list of potential measures to strengthen the EU ETS carbon price signal

The list of proposals for addressing the ‘actual’ or ‘perceived’ shortcoming of the current EU ETS price is long.³

Upping the unilateral EU target to -30% (demand side measure): The ‘natural’ option for member states and the European Commission to consider is to increase the EU’s unilateral 20% reduction target to 30%, as foreseen in the Directive as possibility. This would increase scarcity and reinforce the price signal. To date there is little chance that such a move would be politically acceptable, despite the economic calculations submitted by the Commission that have shown the costs would be less than costs accepted at the time the 20% reduction was agreed. Some also claim that opening the ETS would undermine investment as it undermines predictability.

Set aside (supply side): recognising the difficulties associated with a move to a 30% GHG reduction target, the European Commission has launched the idea of a set-aside, whereby a certain number of EUAs would be taken out of the market either temporarily or permanently. Whether this is feasible is subject to debate; many consider that the political difficulties must necessarily be as great as the more direct approach of acting on the demand side.

Long-term 2050 target embedded in a political agreement is another possible option that has been brought forward by industry and their associations. It aims at supporting politically the downward trajectory that is enshrined in the legislation. Although it must be asked to what extent this is not already in place as a result of the European Council decisions and the Cancún Agreements. And it brings up the essential but difficult issue of the discount factors that businesses apply to such long term Government promises

Decide to review the linear reduction factor and tighten the phase 4 cap: This is an option

that has not been discussed much so far. It will raise the question though, where this leaves the 2020 target.

Price floors & ceilings: Among the most long-standing proposals have been various ideas for price floors and ceilings including the announcement of a minimum price for future auctioning for example in 2030. This ought to distinguish between the very different roles of floors and ceilings, and include the different ways a floor might operate and distribute risk, including by the creation of option instruments *Hybrid instrument combining tax and ETS;* Others have suggested to adjust ETS prices upwards from time to time, essentially transforming the ETS into a hybrid tax-ETS system. The UK for example has taken steps in this direction which have excited much comment.

While other ‘technical fixes’ such as a technology accelerator⁴ possible complementary measures at member state level might be discussed possibly the most far-reaching idea is the establishment of an independent *European Carbon Bank* to increase long-term predictability and notably ensure a carbon price signal that drives low-carbon investment. This would include a mechanism to suppress EUA short-term demand fluctuations by adjusting the supply on a discretionary basis. In the pursuit of a transparent set of objectives understood by the market, and within operational parameters that were also well-understood

5. Format

The Task Force constitutes a unique forum of representatives from the different DGs of the European Commission, representatives from member states, European Parliament, business, and industry, the financial sector, International Organisations, NGOs and other stakeholders to facilitate an in-depth discussion and provide background research.

The new CEPS Task Force will meet **three times between October 2011 and January 2012** (a possible fourth meeting could be added if required).

³ For a detailed discussion see, Egenhofer, C et al, *The EU Emissions Trading System and Climate Policy Towards 2050*. CEPS Special Report, January 2011; pp. 23-25; <http://www.ceps.eu/book/eu-emissions-trading-system-and-climate-policy-towards-2050-real-incentives-reduce-emissions-an>

⁴ A mechanism would support early investors in top performing low-carbon technologies by rewarding them with additional free allowances.

It will be chaired by **Henry Derwent**, President and CEO of the International Emissions Trading Association (IETA)⁵ and previously Director for the UK Government, overseeing among other things the UK's role in the international negotiations and the development of emissions trading at national and EU level. Rapporteurs will be Christian Egenhofer, Senior Research Fellow and other researchers from the energy and climate team.

At the end of the Task Force, CEPS will **publish** and circulate among EU and member state policy circles policy recommendations together with a **CEPS Task Force Report**, which will also be formally published in the CEPS Task Force Report publication series.⁶ This report will be based on discussions in the meetings supplemented by research carried out by the rapporteurs. The Draft Task Force Report will be circulated before the third meeting (in January 2012) to be discussed and approved by the Task Force.

6. Indicative agenda

The indicative agenda of the three meetings is provided in the APPENDIX 1.

7. Conditions for participation

The CEPS Task Force is primarily designed for CEPS Corporate Members but participation is open to non-members as well, albeit at a higher fee.

The fee covers participation in all workshops, documentation, lunches and three copies of all reports produced. Upon request by participants, CEPS will mail additional copies of the final CEPS Task Force Report to persons identified by participants.

Participation fees:

€1.000 for CEPS Corporate Members⁷
€7.000 for non-members

Officials from governments can attend free of charge.

A registration form is provided at the end of this prospectus.

⁵ Henry Derwent became the President and CEO of the International Emissions Trading Association (IETA) in February 2008. Previously, as international climate change Director for the UK Government, he oversaw the UK's role in the international negotiations, in the G8 (especially as Prime Minister's special representative during the UK G8 Presidency in 2005) and in other forums. Henry has been closely associated with the development of greenhouse gas trading in the UK and Europe from its earliest days. He previously had responsibilities for all aspects of climate change and sustainable energy in the UK as well as air quality and industrial pollution control. Before that, he was an international corporate finance executive at a major investment bank.

⁶ For further information, please visit www.ceps.eu or contact Christian Egenhofer at Christian.egenhofer@ceps.eu.

⁷ Regarding information on CEPS Corporate Membership, please contact Staffan Jerneck, Deputy Director and Director for Corporate Relations (staffan.jerneck@ceps.eu) at +32 2 229 3910 or +32 475 903 924.

APPENDIX 1. INDICATIVE AGENDA OF MEETINGS

Does the revised EU ETS market provide the ‘right’ price signal?

Objectives

- an analysis of the ETS price signal, how it comes about and how it works
- Is there something wrong with the ETS price signal? If so, what?
- an examination of second and third-best tools to address low carbon prices and finally, an initial assessment of the institutional, legal and political feasibility of individual measures.

Venue of all meetings:

CEPS, Conference Room, Place du Congrès 1, 1000 Brussels; tel.: +32 2 229 3911 ; www.ceps.eu

1st meeting:

Morning:

Price signals emanating before the EU ETS

Objective of the morning session is to focus on the price signal debate, i.e. issues such as what generates the price signal, how it works, how it differs between the short and long-term and how different actors perceive it.

Possible Speakers:

- **Guy Turner**, Director at Bloomberg New Energy Finance (on fundamentals - short-term and long-term view)
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- **Stig Schjolset**, Energy Analyst, Point Carbon (an analytical view on the set-aside, focusing on the pros and cons and key design challenges for a practically viable set-aside)
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- **Richard Folland**, JP Morgan (Financial sector perspective)
-
- **Peter Zapfel**, DG Clima (comments)
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- Open discussion

Afternoon:

Identifying the problem and possible solutions: Objective of the afternoon session is i) first discuss and identify the key issues around price signals and ii) then identify possible solutions that should be discussed during the second meeting. Possible solutions have been listed under item 5 in the above text.

Possible Speakers:

- Set-aside; e.g. European Commission
- Price floor/ceiling: e.g. Jean-Paul Bouttes, EdF
- Price ceiling: e.g. UK government
- Hybrid instrument: e.g. Allan Larsson or Mons Lönnroth

- Carbon Bank: e.g. Mark Lewis, Deutsche Bank Research

2nd meeting: November 2011

Thinking through possible solutions to the 'low carbon price' challenge

3rd meeting: January 2012

Discussion and agreement of final report



REGISTRATION FORM

Does the revised EU ETS market provide the 'right' price signal?

Person attending the meetings

Salutation: _____ First name: _____ Last name: _____

Job title: _____

E-mail: _____ Telephone: _____

Company

Company name: _____

Postal address: _____

Postcode _____ City _____ Country _____

Contact Person: _____

E-mail: _____ Telephone: _____

Billing information

Tax register number (VAT for Europe): _____

Your reference, Customer Purchase Order No. or Cost Code N: _____

Department: _____

Postal address: _____

Postcode _____ City _____ Country _____

Contact person: _____

Telephone: _____ Fax: _____

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Return to: Isabelle TENAERTS at isabelle.tenaerts@ceps.eu | Tel: +32 229 39 56 | CEPS | 1 Place du Congrès | 1000 Brussels

More information: If you would like to become a member or need more information, please contact Staffan Jerneck at staffan.jerneck@ceps.eu +32 2 229 3910 or +32 475 903 924. Discounted fees for this Task Force will be considered for non-members if they decide to become member of CEPS.