Background Document

Options for Structural Measures in the EU ETS

This paper is intended as a background paper, and will provide the initial thinking/train of thought for the draft CMF response to the European Commission consultation on EU ETS restructuring options, which concludes at the end of February.

It is intended to form the basis for discussion at the CMF EU ETS Task Force meeting on February 1, 2013 in Brussels, with the members of the panels addressing different elements and questions in the paper.

Following the February 1 meeting, a complete draft submission will be prepared that will incorporate the points made during the discussion. That draft will be circulated for further comments, aiming to provide a final version one week before the actual deadline for submissions.

This discussion takes place against the background of a number of ongoing processes, each with their own deliverables and timelines:

- EC proposal for back loading of 900 million EUAs
- EU ETS options that are included in the EC Communication on the state of the EU carbon market
- 2015 international agreement to entry into force in 2020
- The discussion on the EU 2030 package, which is expected to start this year.

- A number of choices will need to be made at the end of this consultative process. They will include:
  - **What**, if anything, needs to be fixed in the EU ETS,
  - How to fix the problem(s), if any
  - Under **which process**, and
  - In **what sequence.**

In order to address these issues, we suggest that the points listed below form the agenda for the upcoming meeting.

a) *EU ETS: purpose and track record*
b) *Questions and the problem(s) that need to be addressed – why are we having this discussion?*
c) *Selection criteria for reform options*
d) *Proposed solutions (based on evaluation of the criteria)*

Points a&b have already been debated during various meetings of the Task Force, but in the context of back loading.

Purpose and track record

- Functioning of the EU ETS must be judged by its track record in meeting the environmental targets in an economically efficient way. This implies good market functioning that delivers a price signal to ensure rational economic decision-making and asset allocation.
- The issue that has triggered the debate on ETS reform is the low price of carbon in the EU ETS, expected to last to the end of the current trading period (2013-2020). This is attributed to a large, and growing, imbalance in the supply/demand equation that, under current conditions, may last to 2020.
- It has always been argued that the EU ETS functions well. Are there signs that we are seeing deterioration in good market functioning? Is there a market functioning crisis that needs to be addressed? Do recent auction failures signal a crisis in EU ETS good market functioning?
- The EUA price has dropped substantially over the last 18 months and has impacted, with many stakeholders, the credibility of the EU ETS to affect long-term change, especially as it relates to the energy matrix. The EU ETS is currently providing a price signal through the contracts traded, but that is short-to-mid term, and is more in the operational time frame. It is clearly responding to the intra-period supply/demand balance, and maybe even shorter term than that.
- Some make the case that the EU ETS short-to-medium term price signal (December 2013 and to 2020), is currently essentially zero, given the forecasted long in the market. Beyond that, there are, what could be regarded, as mixed long-term signals given the current debate over the various road maps, 2030 targets, strong positions that some EU Members States take, etc. However, there is a 2050 goal of 80% de-carbonization (95% for ETS) and a current cap slope of 1.74% that takes the EU ETS to 45% reduction by 2050. Given these realities, is it there truly justified to say that there is no long-term signpost that will produce a long-term price signal?
- However, one must argue that, in reviewing the EU ETS, and as part of the Climate & Energy package, the EU had its sights on reaching a 2050 target. The 2020 target was, and is, an intermediary target. As such, it can, and must be argued, that the signal that the EU ETS delivers must ensure that covered entities make decisions with the ultimate target in mind. What are there arguments against this view? Are current price levels in the EU ETS a symptom of a EU ETS "problem"?

Issues to address

- The debate on the EU ETS has increased in intensity over the last twelve months, sometimes confusing symptoms and causes. A clearer distinction between symptoms and causes may be required; addressing symptoms, but not going to the root cause, may help alleviate the problems temporarily, but not solve them.

- "The State of the European Carbon Market in 2012" Communication identifies the problem as "the growing structural supply-demand balance" in the market and presents a number of options for structural reform. Is this imbalance the only problem, or is the imbalance caused by other issues, which also need to be addressed?
- In this same context, one issue that needs to be discussed is the definition of "structural measures", which touches on the boundaries of this consultation, and review. Structural measures can be interpreted as measures that affect the boundaries of the ETS, its governance, as well as its components – auction, caps, international credits, etc. There are other issues that need to be part of this debate, especially as they relate to "interactions" that impact the EU ETS. Interactions can be seen with different elements, including *climate and energy policy, interaction with enterprise competitiveness and leakage, as well as with international developments in climate change policy*. Are there other types of interaction that needs to be considered?
- The EU ETS target for 2020 was part of the 2020 Climate and Energy package that stipulated the three 20% targets, including the – 20% reduction in GHG emissions. There are three different targets, and three different directives to address those targets, that all impact GHG emissions, and therefore demand for EUA and CERs/ERUs. However, no mechanism was foreseen to address the overlap in impacts on EU ETS demand. Is having three targets, or three policies, that impact the same variable (EUA demand), part of the issue that needs to be addressed?
- The EU ETS was, and is presented, as the principal instrument of climate change policy. In other jurisdictions it is part of the toolbox, but not always the main/principal element. Do we need to ensure certain interrelationships in order to make sure that and ETS can be the main climate change policy instrument, absent which, it then becomes a marginal instrument that provides a short-term price signal?
- The international dimension has been one of the most visible parts of the EU ETS, and its impact, while not to be discussed here, cannot be emphasized enough. The EU ETS was envisaged as providing signals that would move the EU towards a low carbon economy in the context of other jurisdictions introducing a carbon price and linking taking place. What is the interaction with international dimension of the EU ETS – both in terms of being a demand side for offsets as well as in linking? Comparable effort in other jurisdictions may need better understanding. When is linking desirable and feasible? How can "equity", which is expected to play such an important issue in negotiating the 2015 agreement, be accounted for?
- An important interaction is that of the EU ETS with enterprise competitiveness. This interaction has a EU internal dimension given the situation in different Member States, as well as an international dimension – that of leakage. Some Member States address the impact of carbon pricing for electro-intensive industries by subsidies while others find it difficult to do so. If the international interaction is such that there is no widespread and significant presence of a carbon price outside the EU by 2020 through a linked carbon market, how do

we address leakage, and what will be the relationship between and climate and energy policy in addressing climate change?

- Since the start of the EU ETS there has been a strong debate whether the EU ETS is catalyzing technological change. Does the past ETS experience provide enough information on this, or do we need to deepen our understanding on this topic? Carbon emissions have dropped, but it would be important to clarify what has been the impact of the economic crisis and what has been the impact of "change" (lower carbon intensity).
- Those that look at the EU ETS as more than a simple intra-trading period cost minimization tool, would like to see impacts on investment decisions. Can the EU ETS prices provide investors with a long-term economic signal? Are there additional elements needed to provide that long-term price formation, and, if so, what are they?
- The end of first trading period in the EU ETS ended with EUA prices going to zero for a number of objective reasons, including non-bankability, combined with an over-allocation of free allowances. In 2008 a review of the ETS was undertaken that resulted in a number of changes, which improved the functioning of the EU ETS, by addressing problems observed since the start of its operation. At that time, given the limited experience with ETS, this was not seen as being caused by a lack of flexibility, and no mechanism to address this in a systemic was introduced.
- Legitimate demands for "predictability" have led to setting a cap and auctioning schedule to 2020. This was one of the strong demands of many market participants during the EU ETS review. Also very legitimate were the demands for regulatory stability and avoidance of political interference. Set the rules to 2020 and the market will work its magic.
- The rules have turned the ETS from "predictable" to "rigid", with a fixed auctioning schedule leading for demand for "back loading" and "ex ante free allocation, having turned to "rent" in several cases in the current economic crisis. The free allocation situation may repeat during coming years despite the adjustments made to avoid most extreme cases. Non-management of the volume impact of policies overlapping with the ETS has also proven its negative effect on the ETS.
- Have the lack of a mechanism for flexibility, combined with provisions for predictability, result in rigidity and lack of legitimate adaptability, which has become a problem for the EU ETS in rapidly changing and extreme external conditions? Was it really possible to provide a mechanism to adapt to changes that have tested and defied many more established, and tested, economic response measures, in ways unseen in 80 years?

Principles and choices

- One issue raised by many is whether regulatory intervention can be justified in GHG markets, when it does not take place in other commodity markets, which continue to function. However, it must be pointed out that there is regulatory and political intervention in most markets when it moves outside certain

parameters – that was true of electricity in California, was true of currencies, etc.

- The carbon market has a "final", politically decided, ENVIRONMENTAL goal that other markets do not have. The fact that the goal is set through political decision, may justify political intervention, if and when the market signal is not seen to instigate action to reach the long-term ENVIRONMENTAL political goal.
- A cap-and-trade system is seen, by definition, as having a fix cap, set at the beginning of the process. This was the case in the SO2 market, and there was no need for intervention – the rules were set at the beginning of the period. However, the SO2 market can be seen as much less complex and with much less interaction. The scope of the SO2 system was narrower, the time frame shorter and the technology interaction much more limited. Also, there was no international component in the SO2 market, and gas substitution in the US was much less and option at that time.
- Can the argument be made that these special features differentiate GHG markets and support the creation of a mechanism to provide flexibility– in a transparent ad predictable way?
- In making decisions, one should try and set some principles that would guide what choices are made. It is not only important **what the measures taken will be**, but also the **why** and **how**. In this context an intervention that will be perceived as directed to support prices, with will certainly be seen with suspicion and cast a shadow on the credibility of the ETS, the regulator and the political decision makers. Such an impact will be felt not only in the EU, but will reverberate in places where the decision to create and ETS has not yet been made. A such, the fundamental principle that needs to be observed is that any intervention has to
    - Work with the market and avoid or minimize market distortions
    - Ensure that the ETS objectives are met
- Given the EU ETS objectives that were presented above and the issues/problems that need to be addresses we the following solutions should the discussed during the February 1st TF meeting. These solutions are put forward for discussion and for and against arguments are expected, as well as alternatives that the presenters and participants would like to introduce
- There is need for a long-term political sign-post, that will provide the needed market signal – a 2030 target, and maybe beyond.
- A permanent adjustment mechanism needs to be introduced that will have the authority to take action. The mandate/terms of reference of this mechanism should be good market functioning and ensuring that long-term environmental goals, under the overall politically decided cap, can be reached in an economically effective way.
- The institutional realities of the EU have to be present and any solution has to take that into account. Setting "new" institutions to deal with such a politically charged matter is not feasible. Using existing institutions, in different ways, with a clear mandate, may be feasible. This mechanism should be provided with a number of tools that it can use, under predictable circumstances, and

which may include altering the auction schedule, creating a dynamic reserve, etc.

- During the February 1 session, the panelists will examine the proposals in the EC Communication, as well as any other proposals that they may want to bring forward, in light of the preceding discussion around purposes of, and problems identified in the EU ETS.