

Sixth Meeting of the CCMF Task Force on “EU Emissions Trading System”

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Session 3 – What is the problem we are addressing ?

Title : **Flexibility and Rigidity**

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Facts and answers to the questions !

- ◆ The market is not functioning well **YES/NO**
- ◆ The prices of EUAs is too low **YES**
- ◆ There is no long term price signal and not catalyzing long-term technological change **YES**
- ◆ There are overlapping policies that affect the price of EUAs and no coordinating mechanism between them **YES**
- ◆ Climate and energy policies are treated separately in the EU **YES**
- ◆ There is no flexibility on the supply side in the EU ETS **YES**
- ◆ Demands for predictability/stability have led to rigidity **YES/NO**
- ◆ The EU ETS does not incorporate provisions to address the interrelationship between climate, energy and competitiveness **YES**
for climate and energy (competitiveness is however tentatively treated)

Flexibility and Rigidity - 1

◆ Characteristics of the supply and demand in a cap&trade system !

- The supply is, at first, by essence inelastic as one works under a cap
- But as far as we move along time supply mitigation options show up and elasticity varies accordingly
- Uncertainty is the rule in general
- Other policies and /or economic situation interact with EU ETS and can influence significantly the demand side
- There are really two or three time scales in the process : the long term setting of the cap, the medium term binding target, and the way allowances are delivered within this cap

◆ Why an ETS should be rigid ?

- The fundamental idea from the economic theory is that the ETS is first an instrument that sets the environmental cap at a fixed horizon of time
- As far as the GHG problematic is expressed through the science, one has, in a sustainable manner to reduce the carbon emissions progressively (that means that they have no to increase again !)

◆ Why an ETS should be flexible ?

- Many reasons prone in favor of some flexibility to be introduced
- At start inelasticity of supply options make the cap and trade less attractive than a tax but the situation is the reverse as we move into the future (see upper bullet point)
- Inherent inelasticity of the supply (the supply is fixed) gives to this market a character more artificial than others (the most striking feature is it is created by an administrative authority : it is a regulatory instrument in which scarcity is more and more the rule over time)

Flexibility and Rigidity - 2

- ▶ **One has to find rationales to demonstrate that EU ETS must be rigid and flexible at the same time !? Do we want really to get the least cost options ?**

- ▶ **Not losing the flexibility of the market principles together insuring that the latter will develop the right incentive to invest in a sustainable way**
 - Avoiding the paradox we are facing since 8 years :
 - two first periods are “easy” ones with free allocation and a moderate constraint but with periods of **high carbon prices**
 - now constraint is higher with phase out of free allocations for the power sector but **low carbon prices** not in line with incentives to invest for the long term

- ▶ **Another requirement is that we want to reduce the emissions of our economy at the least cost which was one of the paradigm that gave birth to EU ETS**
 - EU ETS should then be the instrument that will help to decarbonise the EU Economy at the least cost provided that we have no in place other constraining policies that might interact with the perimeter of interest where one tries to create incentives
 - What least cost do we want ? Is it a least cost on the residue of all the other policies, each 10 years of time ? A consequence of this is that one might reduce emissions in fact at the higher cost and not at the least cost !
 - Do we want really to reduce emissions at the least cost on the long term ?

EU Climate Energy Package

The EU ETS rules have changed significantly for the period post 2012,
compared to phases 1 and 2

They have to change again to increase the visibility, and one has to depart from a piecewise
implementation of the policy giving too much importance to short term arbitrage

	EU ETS Phases 1&2	EU ETS Phase 3	EU ETS Phase 4 and beyond
	2005-2007 and 2008-2012	2013-2020	2013-2030 +Roadmap 2050
Period	3 and 5 years	8 years	~ 20 years ?
Allocations to existing installations	Free	General rule : auctions	AUCTIONS
Allocations to new projects	Free	Auctions except for some rare exceptions	NO
Subsidiarity	High (National Allocation Plans)	Low or non-existent in the long term	NO
Banking	Generally not authorised between phase 1 and 2	Authorised as of phase 2	YES