# EFET Response to EC Consultation on

# Structural Options to Strengthen the EU Emissions Trading System

**28th February 2013**

The European Federation of Energy Traders (EFET)[1] welcomes the initiative of the European Commission to look into structural options to strengthen the EU Emissions Trading System (ETS). It is our belief that the system has proven to be *the* EU policy tool to reduce greenhouse gas emissions at lowest costs. It has set an international precedent and has encouraged other countries to set up their own emissions trading schemes. As international climate talks stand, the linking of national emission trading schemes seems to be the only promising *global* approach for climate action in the foreseeable future.

The fundamental role of the EU ETS is to provide long-term investment signals for low-carbon technologies and to trigger the use of existing already competitive carbon-abating technologies, such as fuel-switching or onshore wind. Currently, however, the system falls short of delivering on these objectives. The market for EU Emission Allowances (EUAs) is oversupplied partly due to the continuing recession and partly due to the promotion of low carbon electricity generation mainly through national renewable support schemes.

In view of these adverse conditions, we consider a prompt structural reform of the EU ETS to be of paramount importance for restoring market confidence and improving the credibility of the system. Without a swift and decisive EU ETS reform we will experience a prolonged period of low EUA prices, during which the EU ETS will provide no signal for investment in low-carbon technologies. As a result, the decarbonisation of the European economy will suffer from a significant loss of momentum.

In the following paragraphs we offer our views on the six options for structural reforms presented in the *Report from the Commission to the European Parliament and the Council on the State of the European Carbon market in 2013* from 14th November 2012.

**EFET supports Option C (Early revision of the annual linear reduction factor).** An early revision of the annual linear reduction factor would provide a clear signal to investors in the compliance sectors that the ETS will continue to play a decisive role in the transition to a low-carbon economy by 2050. Such a signal would re-establish the much needed trust that the ETS is there to stay. It is this lack of trust that is at the heart of the current price decline.

[1] EFET promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

To avoid losing a decade for the decarbonisation of the EU economy, the annual linear reduction factor should be revised as *early as possible*, i.e. within the current trading phase. If the EU was to set a 2030 goal consistent with the agreed EU long-term objective of 80-95% reduction by 2050 compared to 1990 levels, this would require a minimum reduction factor of 2.6% p.a.. Such a steep increase from 1.74% p.a. in phase 3 to 2.6% p.a. in phase 4 would risk continuing carbon-intensive operations until 2020, followed by an abrupt change after 2020. Only in theory would financial intermediaries smoothen eventual price differences between the different trading phases through carry trades. In reality, we witness an increasingly limited ability and willingness to bear the associated costs of carry by market participants.

However, we acknowledge that there are legitimate concerns about a substantial change of market rules within an ongoing trading phase and that there is a substantial risk that the debate about a structural reform of the ETS would be diluted and prolonged by those concerns. To achieve regulatory certainty quickly, it is of utmost importance that a decision on a new linear reduction factor (and hence, a decision by the co-legislators on a revised ETS Directive) is made as early as possible, i.e. well before the end of phase 3. The risk of sidetracking/ prolonging the debate must be weighed against the priority goal of achieving an early revision of the ETS Directive. Such an assessment might lead to a decision to revise the linear reduction factor only for the forth and subsequent trading phases.

**EFET supports Option B (Retiring a number of allowances in phase 3) as a complementary measure to Option C.** The ETS requires an adjustment of the quantity of allowances *now*. As stated in our Response to the EC Consultation on a Review of the Auction Time Profile for the EU Emissions Trading System, EFET supports the back-loading of a number of allowances as a response to the imminent risk of a substantial loss of trust in the EU ETS due to the dramatic price decline over the past few months. Those back-loaded allowances should not be brought back into the system. Ideally, they should be permanently withdrawn from the system as part of a revised annual reduction factor, applied already within phase 3. In case such an early revision is not feasible (see above), the retirement of a number of allowances in phase 3 should be pursued in a separate decision.

**EFET also supports Option A (Increasing the EU reduction target to 30% in 2020) as a complementary measure to Option C.** As stated above, a revision of the annual linear reduction factor should be at the heart of any structural reform of the ETS. Such a revision should ideally be deducted from agreed EU-wide interim reduction targets for the years between 2020 and 2050. As such, an increased EU reduction target for 2020, in line with the agreed EU long-term objective of 80-95% reduction by 2050, would be the logical consequence of any structural reform.

However, there again we see a substantial risk that the debate about a structural reform of the ETS would be diluted and prolonged by the discussion on revised 2020 targets, because its impact is beyond that of the EU ETS as it affects the EU economy as a whole. This risk should be weighed against the priority target of achieving a *quick* decision on a revised ETS Directive.

**EFET supports Option D (Extension of the scope of EU ETS to other sectors)**, acknowledging that a number of questions about the sectors/ gases which could be included in the EU ETS and the way in which this could take place remain unanswered. It is also important to note that such an extension of the scope should not jeopardise the timely implementation of Options A, B and C, and should therefore be considered separately.

With regards to **Option E (Limiting the use of international credits)**, in our view such a step should be considered in light of the progress made by the United Nations Framework Convention on Climate Change. In addition, every effort should be made to enable the linking of the ETS with other trading schemes. Further limits to the use of international credits should be assessed against the potential barriers to linking these might create.

**EFET does not support measures presented under Option F (Discretionary price management mechanisms).** Discretionary price management mechanisms require the establishment of a politically independent institution governed by a clear and robust mandate in order to reduce frequent and unexpected supply side interventions. EFET considers such an independent institution to be difficult to set up. Preserving its political independence over time would be even more difficult. It would certainly add complexity to the system. Additionally, we believe that financial institutions or intermediaries would be able to fulfil the same function of managing the supply of EUAs if they can trust the ETS to remain *the* EU mechanism for responding to climate change challenges.

However, we would be interested in exploring mechanisms to mitigate imbalances from massive changes in demand. For example, it might be worth exploring the feasibility of following the example of the Australian emissions trading system – the rolling five-year cap might provide both market certainty and flexibility to adjusting to changing macro-economic conditions.

**To conclude**, the EU is on track to achieve its climate targets up to 2020, but it is in danger of falling seriously behind after 2020, because the investments that are needed to get to the next level are not being made today. A structural reform of the EU ETS would help to restore market confidence and reduce uncertainty about the continuation of the system, which, in turn, would revive the ability of the system to provide clear investment signals. To yield the desired benefits, any such reform would also have to be accompanied by greater coherence between the EU ETS and other EU climate policies, such as energy efficiency and renewable energy support schemes. Particularly, harmonised support schemes across the EU, fully integrating RES producers into market mechanisms, are necessary to deliver a level-playing field for investment in renewable energy production, to deploy renewable energies cost-efficiently and to preserve the European internal electricity market.