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Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC

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EFET comments to the European Commission – 08 September 2015

The European Federation of Energy Traders (EFET[1]) welcomes the opportunity to provide its feedback on the legislative proposal to amend the EU Emission Trading System (EU ETS) Directive, as published with date 15 July 2015.

EFET is firmly convinced that a reformed EU Emission Trading System (EU ETS) will deliver the objectives of the EU energy and climate policy and reduce carbon emissions in a cost-effective manner across the whole economy. We also agree that it should be the central pillar of EU climate policies going forward.

A well-functioning EU ETS will certainly be the most adequate EU policy tool to reduce greenhouse gas emissions at the lowest cost. It has also set an international precedent and encouraged other countries to set up their own emissions trading schemes. Currently in international climate talks, the linking of national emission trading schemes seems to be the only promising global approach for climate action in the foreseeable future.

However, we believe that some additional work is needed in order to ensure that it becomes the "main instrument" to achieve the European emission reduction target, as reiterated by member states in the Council conclusions of 23 October 2014 and in the Energy Union package.

In this context, we welcome the European Commission's intention to revise the EU emissions trading system (EU ETS), as an integral part of the work on achieving a resilient Energy Union with a forward-looking climate policy[2] as well as the Commission's Energy summer package on "*Transforming Europe's energy system*", which clearly insists on the key role of a well-functioning EU ETS for the Power market design, as "*Europe's flagship tool for tackling climate change and to place the EU on track towards a low-carbon economy*"[3]. **These distinctive and coherent political orientations provide the Commission and all stakeholders a very clear mandate to discuss all aspects of the EU ETS market design in order to ensure that these ambitious objectives are reached.**

[1] EFET, The European Federation of Energy Traders (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

[2] http://europa.eu/rapid/press-release_MEMO-15-5352_en.htm

[3] http://europa.eu/rapid/press-release_IP-15-5358_en.htm

General context

The market for EU Emission Allowances (EUAs) was oversupplied with a surplus of 2.1 billion EUAs in 2013. EU COM expects this surplus to rise to up to 2.6 billion EUAs by 2020.

A variety of factors have led to this situation, of which some may be considered as historical or "temporary" (such as the initial market design features or the macroeconomic recession) but others should be considered as "structural", such as the progressive decoupling of emissions from GDP due to the ongoing evolution towards a less energy intensive economy. Moreover, political factors such as overlapping policy measures have substantially contributed to this continuously increased surplus. This has prompted a prolonged period of low EUA prices, therefore the EU ETS has provided little or no signal for investment in low-carbon technologies.

When reforming the EU ETS, all these factors as well as the time needed to reduce this surplus will need to be clearly identified and quantified in order to adequately reform the EU ETS and to restore market confidence into the EU ETS, eventually leading to clear and reliable price signals for low-carbon investments.

It is indeed of particular importance that the accumulated surplus is removed and not further increased. The impacts of past and future promotion of low carbon electricity generation or any other out-of-the-market mechanisms need to be duly quantified, published and as much as possible neutralised so that the EU ETS dynamic is not affected by non-market-based supplementary measures implemented at Member States or EU-levels.

This will ensure that the EU ETS progressively becomes the unique central tool, common to all EU member states, any additional measures being progressively considered as "not part of the EU ETS objectives".

In this paper, we present some general recommendations fit for any market design (such as full transparency on fundamental data), as well as some "missing points", which we would like to be addressed with urgency by the EU institutions to ensure the EU ETS market design if fit for the purpose of achieving Europe's energy and climate objectives.

Full auctioning of allowances should be the ultimate goal

EFET strongly supports the position of EU member states, outlined in the October 2014 Council Conclusions, that **the share of allowances to be auctioned will not be reduced**. In the current legislative proposal we are pleased to see that this principle is respected.
However, we would like to also note that, ultimately, free allocation should be considered as a transitional measure: **the ultimate goal should be the full auctioning of allowances.** During the forthcoming UN Climate Change conference, COP 21, the European Union will need to show strong leadership in the climate talks and pave the way towards full auctioning as the most transparent allocation method which rewards efficiency and climate-friendly investments.

Ultimately, full auctioning is required to ensure efficient price discovery, and to ensure that the transition to a low carbon economy is at the lowest cost to society. Therefore, over time as the lowest cost carbon abatement options are deployed and as international agreements are reached in order to address the issue of carbon leakage, it is essential that that an increasing proportion of emissions are covered by auctioned allowances. The proportion of auctioned allowances should increase with the progressive decrease of carbon leakage concerns, thus ensuring an efficient market based least cost emissions reduction pathway.

The expansion of the ETS perimeter in order to cover other sectors or to compensate excess emissions may also be one way to extend the efficiency of the EU ETS, as this would create a larger pool of allowances and a larger perimeter for decarbonisation investments (see below).

Ultimately, the costs of carbon leakage should be met by means other than free allocation, which could include using some of the revenues from auctioned allowances. In any case, compensation needs to be addressed separately from the ETS. Indirect carbon costs must not be compensated through free allocation as this would distort the market, but through financial compensation within the framework of state aid rules.

Allocation of free allowances to prevent the risk of carbon leakage

EFET welcome the Commission's proposals to ensure that free allocation is better targeted in order to more accurately reflect emissions from the most efficient installations at genuine risk of carbon leakage. Transparency and predictability are important principles for a well-functioning trading system. Dynamic or ex post allocation are from our understanding not in line with a predictable EU ETS. For this reason, we welcome the rule-out of '*dynamic*' or '*ex post'* allocation of free allowances for carbon leakage. We believe that the Commission's proposal of more frequent updates of activity levels and benchmarks *ex ante* strikes a good balance between the need for more flexibility whilst not undermining certainty. However, we believe that they should be reviewed more regularly than proposed.

Review of industry benchmarks & activity levels

EFET welcomes the proposal for more frequent reviews of benchmarks and activity levels. We believe that the frequency of revisions must balance sufficient certainty for investors whilst also reflecting the latest technological developments. A revision every two to three years would be, in our view, the best solution, taking into account the need to have accurate indicators whilst avoiding excessive administrative complexity.

Use of unallocated allowances

EFET expresses reservations about the use of unallocated allowances for a new entrants reserve and an 'innovation fund'. We understand that 50 million unallocated allowances from the MSR will be made available for innovation before 2021 and that the new entrants reserve will also include 250 million allowances set aside from the MSR (plus another 150 million allowances not allocated to sectors not considered at risk of carbon leakage).

These measures do not appear justified in current oversupplied market conditions and will set a negative precedent that may undermine market functioning and politicise the MSR.

Missing points of the current ETS Directive legislative proposal

Overlapping policies and interaction between the ETS Directive and other relevant EU energy and climate legislation

EFET believes that the EU Institutions should ensure greater coherence between the EU ETS and other EU climate policies, which should be gradually phased out: the EU ETS must prevail as the central measure for abating CO2, while the effects of subsidy/promotion schemes for RES and energy efficiency should be quantified and taken into account in the amount of emissions to be allocated.

EFET has supported the introduction of the Market Stability Reserve (MSR) and we believe that its implementation will form an important contribution to the EU ETS reform, as part of the post-2020 market design.

However, we believe that the introduction of a Market Stability Reserve (MSR) is not meant to tackle overlapping policies and does not provide a protection against a further build-up of oversupply if emissions are reduced via out-of-the-market policies. The ability of the EU ETS to deliver on its decarbonisation objectives will require more comprehensive structural reforms to restore trust and confidence in the system.

The ability to achieve the EU climate policy objectives will largely depend on the ability to ensure consistency between the cap and trade system and other EU policies on renewable energy and energy efficiency. The overlap between different climate policies directly underminea the EU ETS by reducing demand for energy and EUAs, thus acting as a 'substitute' to the EU ETS. This results in inefficient and costly carbon abatement actions, as marginal cost of abatement of out-of-market mechanisms is much higher than EU ETS carbon price. Overall, the current overlap of EU and national instruments to pursue greenhouse gas reduction, CHP, renewable energy and energy efficiency targets, in our view, has clearly failed to provide efficient market-driven investment signals in low-carbon technologies.

EFET believes that the negative effects of overlapping climate policies should be tackled with matter of urgency before the start of Phase IV: this is of the utmost importance for the future functioning of the EU ETS and a well-functioning power market.

In our view:

- Firstly, EU Institutions should **ensure that carbon reductions made through out-of-market policy mechanisms have no effects on the EU ETS dynamics:** the three EU 2030 targets, related to CO2 emissions, RES consumption and energy efficiency are interdependent and they have –among others - the common aim to reduce greenhouse gas emissions.

Therefore, **carbon reductions achieved through out-of-the market policies should be accounted for and factored in ex-ante in a transparent manner in the determination of EUA volumes for Phase 4**. Consequently, the expected CO2 abatement coming from RES promotion, energy efficiency or other national policies like national CO2-taxes over Phase 4 should be made transparent and fully taken into account ex-ante in the calculation of the available EUA volumes. Such adjustment may be done based on the expected effects of national policy actions member states have to report to the Commission. Nevertheless, we stress that **ex-post adjustments to the cap or volumes during and after phase IV must not be applied**. Market participants need regulatory stability to be able to take positions and provide liquidity into carbon markets: ex-post adjustments would risk to create uncertainty in terms of the volume of allowances to be auctioned and hence non-market based volatility in the price of EUAs. This calls for no additional EU or local policy interventions during Phase IV once the initial parameters of the EU ETS for this phase have been set up.

- Secondly, EU member states should progressively remove financial support for mature RES-E technologies thanks to their increasing competitiveness and the emergence of an adequate CO2 price signal, in line with EU climate policy ambitions. National RES support mechanisms within the EU have had the effect of forcing exogenous emission reductions in the power sector, which has significantly reduced the demand for EU emission allowances, thus depressing CO2 prices. As stated e.g. by the German Commission of Experts for Research and Innovation[4] "*The climate protection argument, which is often cited to legitimise the EEG, does not hold true. The European emissions trading system (EU ETS) defines a fixed EU-wide ceiling for CO2 emissions across energy-intensive industries. The expansion of renewable energies in Germany's power supply induced by the EEG therefore does not result in additional CO2 emission reduction at the EU level, but merely shifts emissions to other sectors and other EU countries covered by the EU ETS. Thus, the EEG does not lead to more climate protection, but just induces additional cost.*" This again has reduced the incentive to invest in other emissions reductions in the power sector thus increasing the overall cost of emissions' reduction for the EU. This has led to a number of negative effects on other policy objectives, especially the completion of the single electricity market in a cost-efficient way.

Only when such structural reforms are carried out will the EU ETS be able to progressively play the central role it was designed for and ensure that emissions are reduced cost-efficiently through a market-based mechanism. A unique, reliable carbon price signal will then provide a level playing field in all member states for achieving decarbonisation objectives, promoting renewable energy and increasing energy efficiency.

Transparency

Transparency on fundamental market data/assumptions and its timely publication is key to ensuring market confidence. Members States and the EU Commission still fail to provide detailed fundamental data at local or aggregated level, particularly on economic growth (GDP growth) and carbon intensity (emission per unit GDP) . This has among many other issues also been criticized in the recently published Report from the European Court of Auditors[5]. The functioning of the EU ETS would substantially improve if the EU would impose stricter rules on supply and demand of EUAs.

[4] EFI Commission of Experts for Research and Innovation, Research, Innovation and Technological Performance in Germany, Report 2014, p. 52

[5] European Court of Auditors, The integrity and implementation of the EU ETS, Luxemburg 2015

MSR

The MSR must impact the EU carbon market in two ways: first, by tackling the build-up of future oversupply (for example in case of future economic slowdown) or undersupply (once the current surplus will be removed); and second, by smoothening potential price shocks when the supply-demand balance becomes tight or loose.
The MSR can achieve this in a predictable, rule-based manner, avoiding ad hoc regulatory intervention.

We applaud the establishment of the MSR and welcome the political agreement reached but we also re-iterate our view that **the rate of extraction should be higher than 12% to ensure the swift reduction of oversupply and return to balance of the EU ETS so that it can play its stabilization role.** EFET supported the proposal[6] to increase the extraction rate by introducing a supply adjustment equal to 33% of the difference between the surplus and the upper end of the band, as introduced by Sandbag[7]. This proposal should have been considered, as this would have helped to accelerate the extraction rate when it is most needed, while slowing it down as we get closer to the target. This would have also sent an additional clear signal of support for the EU ETS.

Role of International credits

The EU ETS Directive legislative proposal does not clarify the role of the other flexible mechanism established under the Kyoto Protocol (Joint Implementation and Clean Development Mechanism credits). EFET believes that International credits can provide vast amounts of opportunities for cost-effective emissions reductions at the global level.

Whilst we acknowledge the importance not to undermine the EU ETS and the care that needs to be taken when designing such measures, we believe that international credits would play an important role in the longer-term, especially in the context of international agreements and carbon linkage discussions. Such mechanisms may play an important role in facilitating discussions on global emissions trading markets: to achieve the goal of a worldwide trading scheme, the EU should also prepare to link the ETS to other cap-and-trade schemes.

Extension of the EU ETS scope to more sectors and to small installations

We believe that the EU ETS should be extended to more sectors. In order to expand its role as a central pillar of EU climate policies and increase liquidity in the market, we support the extension of the EU ETS to new sectors, provided that the impacts to the EU ETS balance are well understood, managed and published and that the EU ETS cap is adjusted accordingly. We see the small heating and road transport as natural candidates for inclusion in the EU ETS, and urge for their inclusion as soon as practicable.

Indeed, EFET believes that the ETS scope should be extended to small installations: for example, the current scope of the ETS typically does not cover installations on the heat market below 20 MW. In light of a stronger CO2 price in the future on the one hand and the trend to more decentralised generation on

[6] EFET position paper on the EC proposal for a Market Stability Reserve
[7] The Sandbag response to the Commission's proposal for a Market Stability Reserve is available here: http://www.sandbag.org.uk/site_media/pdfs/reports/Policy_Briefing_on_the_Market_Stability_Reserve.pdf

the other hand, it means that efficient solutions such as district heating will bear the costs of CO2 while potentially less efficient and more polluting competitors, such as individual and block heating, are exempted from corresponding costs for emissions abatement. These distortions of competition make small individual boilers more competitive but contradict the EU's long-term decarbonisation objectives. The revision of the EU ETS Directive should therefore look into ways to establish a level playing field between large and small installations and that all emissions associated with power generation are exposed to a CO2 price.