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Vattenfall's comments on the European Commission's proposal for a revision of the EU ETS directive for the post-2020 period

Introduction

Vattenfall welcomes the European Commission's legislative proposal to revise the EU ETS directive, as tabled on July 15th. The measures in the proposal largely reflect the intentions set out in the Council's conclusions for the 2030 framework from October 2014 and supplement the steps which are already taken in the EU ETS reform, incl. the Market Stability Reserve (MSR), in a necessary process to further improve the EU ETS policy and prepare it for the 4th trading period which starts in 2021. By taking these actions now, the EU sends a clear signal to the COP21 negotiations in Paris later this year about its 40 % GHG emissions reduction target for 2030 now turning into legislation and its commitment to give the EU ETS policy a central-pillar role in achieving the EU's climate objectives.

Linear Reduction Factor

Vattenfall believes that the most important measure in the legislative proposal is the revision of the Linear Reduction Factor (LRF) from 1.74 % to 2.2 %, starting from 2021. This measure is absolutely essential in order to align the EU ETS allowance cap with the EU's long-term climate objectives which have been adopted for 2030 and 2050. The new reduction rate of 2.2 % per year represents the lower end of the EU's climate target of "at least" 40 % domestic reductions of GHG emissions until 2030. It means that should the EU adopt a more ambitious 2030 target than 40 %, in the light of an ambitious global climate agreement, then the LRF needs to be further revised accordingly.

Share of auctioning

Vattenfall supports the view that a majority of the ETS allowances shall be distributed through auctioning after 2020. Auctioning contributes to a clear CO2 price signal and incentive to reduce GHG emissions in the EU ETS. The domination of auctioning as a means to distribute ETS allowances is a natural consequence of the fact that electricity production does not, by principle, receive any free allocation after 2012. A stable and reliable supply of ETS allowances on the auction platforms is necessary, not only for the revenues that accrue to Member states, but for ensuring transparency and a sufficiently liquid market at all times, which is particularly important for the power sector which no longer receives any free allocation but instead depends on the auctions.

It can nevertheless be questioned whether fixing the share of ETS allowances to be auctioned at 57 % after 2020, as proposed by the European Commission, is the right approach, since the ultimate objective should be to gradually move to full auctioning across the entire EU ETS. Though, exactly by which pace this can be achieved clearly depends on how the climate policy situation develops on the global scale and to what extent the EU's energy-intensive industry's main competitors face comparable CO2 restrictions in the future.

Carbon Leakage

Vattenfall believes that carbon leakage can become a serious issue as the CO2 price is strengthened and that compensatory measures therefore might be justified. However, it is important that such measures are concentrated to the industries which are really exposed to a genuine risk of carbon leakage. For that reason, it is a step in the right direction that

the European Commission now proposes that the ETS allowances which are available for free allocation will become more targeted towards the most vulnerable sectors after 2020. Both direct and indirect costs need to be taken into account when assessing the risk of carbon leakage and the need for compensation. There is also a large scope for making the compensation of indirect costs more harmonized within the EU.

Vattenfall supports the European Commission's approach to make the free allocation better aligned with changing production levels, as requested by the European Council in their conclusions on the 2030 framework, by using more recent production data when applying benchmarks as well as to allow significant production increases to receive free allocation from the Phase 4 New Entrant Reserve (NER), in addition to the capacity additions (and completely new installations) which are eligible today.

Unallocated allowances

Vattenfall considers that the agreement to introduce a Market Stability Reserve (MSR) was a very positive achievement, which will contribute to making the EU ETS policy more robust in the future. Short-term, it can also play an important role in addressing the large over-supply of ETS allowances in the market. However, the political agreement on the MSR is a compromise, as it will not start to operate until 1 January 2019. Therefore, it is of outmost importance that the MSR's potential to withhold surplus ETS allowances is not further watered-down. The allowances which are placed in the MSR should not return to the market before the legally pre-defined criteria in terms of market scarcity are fulfilled.

According to the European Commission's proposal, 250 M EUAs shall be taken from the MSR and placed in the Phase 4 New Entrants Reserve (NER). In Vattenfall's view, a more suitable solution would be to create the Phase 4 NER by taking EUAs from the Phase 4 allowance cap, in exactly the same way that the Phase 3 NER was created by taking EUAs from the Phase 3 allowance cap. In order for the MSR to be as effective as possible in addressing today's massive surplus of allowances in the ETS market, the initial size of the MSR must not be scaled down in order to allow a larger ETS allowance cap in Phase 4.

The new funds

Vattenfall welcomes the decision to extend the NER300 programme beyond 2020, and to scale up its initial funding with another 400 M EUAs, for supporting innovative climate and energy projects across the EU. However, this should be possible without taking 50 M EUAs from the amount of ETS allowances which have been placed in the MSR.

Further, it is important to pay careful attention to the timing for monetising these EUAs, because depending on when they reach the ETS market it might counter-act the MSR's efforts to reduce the surplus in the EU ETS market and also generate less revenues than anticipated. The same applies for the Modernisation Fund which has also been proposed by the European Commission.

Missing aspects

Vattenfall considers that the following aspects are insufficiently addressed in the European Commission's proposal:

- *International credits:* Although the EU's 2030 climate target of 40 % is to reduce GHG emissions by domestic action only, it would have been suitable to address the future role of international mechanisms linked to the EU ETS as a part of this review. Internationally recognized mechanisms with high environmental integrity can play an important role in building a more global carbon market and should be

considered for use in the EU ETS in case the current “at least” 40 % target for 2030 is increased beyond 40 % in the context of a global climate agreement.

- *Expansion to other activities:* A problem with the EU ETS is that it only covers a part of the heat market. This leads to a distortion of competition, at least in some Member states, and a risk of intra-EU carbon leakage. A solution could be to add fuel suppliers into the EU ETS or by other means exposing individual heat boilers to an adequate carbon pricing signal.

- *Overlapping policies:* Even if the necessary steps to structurally reform the EU ETS directive are properly implemented, the question whether the EU ETS will actually become the main instrument for decarbonising the EU economy depends to a large extent on what happens to other over-lapping EU and national policies in the meantime. Although these policy interventions can have a reducing effect on the local or regional CO2 emissions, the only effect from an EU-wide perspective is a geographical displacement of CO2 emissions and a weakening of the international CO2 price signal. To be successful in strengthening the EU ETS policy, these aspects must therefore be carefully considered in the wider context of EU and national policy making.