The voice of the energy industry

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Position on the European Commission's proposal to amend the EU Emissions Trading System (EU ETS) Directive

7 September 2015

Introduction

Energy UK is the trade association for the energy industry. We represent over 80 members comprising generators and gas and electricity suppliers of all kinds and sizes as well as other businesses operating in the energy industry.

Together our members generate more than 90 per cent of the UK's total electricity output, supplying more than 26 million homes and investing more than £13 billion in the British economy in 2013.

This paper comments on the European Commission's proposal[1] to amend the EU Emissions Trading System (ETS) Directive, which was published in July this year. The proposal:

- *translates the 43% greenhouse gas reduction target in 2030 in the ETS into a cap declining by 2.2% annually from 2021 onwards, corresponding to an additional reduction of around 556 million tonnes of carbon dioxide in the period 2021-2030 compared to the current annual decline of 1.74%.*
- *builds on the positive experience with the harmonised rules implemented since 2013, by further developing predictable, robust and fair rules for free allocation of allowances to industry to address the potential risk of carbon leakage in an adequate manner.*
- *contains several funding mechanisms to support economic actors in the power sector and industry in the innovation and investment challenges they face in the transition to a low-carbon economy.*

Position statement

Energy UK welcomes the Commission's proposal. We support delivering carbon-neutral electricity in Europe by 2050 and ensuring a competitively priced, reliable electricity supply throughout the integrated European energy market. Energy UK considers that it is essential that EU climate policy supports competiveness by promoting reductions of greenhouse gas emissions in a cost-effective manner through the use of an ETS market mechanism. For this

[1] Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments. COM(2015) 337 final. 15 July 2015.

reason, Energy UK supports a strong ETS because we see this as the best way to provide affordable, reliable, and sustainable electricity to the EU economy.

Linear reduction factor

Energy UK supports the proposed change in the annual linear reduction factor of the cap from 1.74% to 2.2% to achieve a 43% cut in ETS sector emissions by 2030 compared to 2005. If, subsequent to the Paris COP21 meeting, Europe decides to go beyond a 40% greenhouse gas reduction target, there is some potential to achieve this through the EU ETS, given the current surplus in the market.

Carbon Leakage and the case for free allocation

Full auctioning of allowances is ultimately required to ensure efficient price discovery and to ensure 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 the ETS cap tightens, it is essential that that an increasing proportion of emissions are covered by auctioned allowances. While it is appropriate that the pace with which the proportion of auctioning increases takes account of the impact of carbon leakage, it must also ensure an efficient market and a least-cost emission reduction pathway. Expansion of the ETS to cover other sectors may be one way of alleviating the situation, as this would create a larger pool of allowances. The implications of bringing in new sectors, including the impact on the cap, should be fully analysed before any such decision is taken.

It is essential that the volume of allowances available to carbon leakage sectors is explicitly defined and is not subject to ex-post adjustment, as this would create uncertainty for the electricity sector as to the volume of allowances available for auctioning, with consequences in terms of market liquidity and price volatility. Energy UK would suggest that industry benchmarks and free allocation should be reviewed on a three-yearly basis to maintain the incentives on industry to decarbonise.

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. If the EU decides it should decarbonise ahead of the rest of the global economy, then it must do this in full awareness that it either is prepared to see production from carbon leakage exposed industries move out of Europe or be prepared to pay fair compensation for the costs that result from this decision. As the ETS cap shrinks, the inevitable consequence is that the costs of compensation will have to be found outside the ETS.

Low-carbon financing mechanisms

The proposed new support mechanisms, or the extension of existing ones, will be key to achieving political agreement on the package of EU ETS reforms. However, because the investment cycle in the electricity sector is long and complex, operators must have certainty as to how and when the associated allowances will come to market and what the volumes will be.

Access to International Allowances and Credits

The Commission's legislative proposal is silent on the issue of access to international carbon allowances and credits from the other flexible mechanisms established under the Kyoto Protocol (Joint Implementation and Clean Development Mechanism credits). While the outcome of the COP 21 negotiations in Paris in December 2015 remains to be determined, the aspiration is for a strong binding international agreement which makes substantial progress towards achieving the 2ºC global climate change target. Putting a global price on carbon, whether through taxation or a market-based instrument, will be a key element of any meaningful agreement. A considerable number of fledgling carbon emissions trading schemes are emerging around the world and it will be important for the EU to be seen to recognise and support these if significant progress is to be achieved in Paris, including through allowing access under the ETS to international allowances (via linkage) and credits. Of course, it is important that the use of international credits does not exacerbate the problem of over-supply of ETS allowances. Nevertheless, if designed in the right way, such a mechanism could mitigate the impacts of carbon leakage on EU competitiveness while EU climate targets remain more ambitious than those of other parties to any international agreement, as well as facilitating the transition to a global carbon market.

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