

Tackling overlapping policies with the EU ETS



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Executive Summary

EFET¹ is firmly convinced that a reformed and well-functioning emissions trading system (ETS), together with carbon reduction targets, is the most cost-effective means of achieving the objectives of EU energy and climate policy”. However, today’s reality is that the EU ETS is drastically oversupplied, prompting a prolonged period of low EUA prices. Arguably, the EU ETS now plays a residual role in decarbonisation.

If the EU ETS is to regain a central role, it is crucial that the EU Commission ensure consistency between the EU ETS as a cap and trade system on one hand, and other climate policies (such as renewable energy, energy efficiency) on the other. We believe this is a much more crucial issue for the future of the EU ETS than the risk of carbon leakage, for which the European Commission has so far found no evidence² but is nonetheless monopolising the current policy discussion.

It is to the detriment of EU consumers that the central role of the EU ETS is now at risk. ‘Out of the market’ or ‘overlapping’ climate policies³ that have been introduced have directly undermined the effectiveness of the carbon market, by reducing demand for energy and EUAs, thus acting as a ‘substitute’ to the EU ETS. This has resulted in inefficient and costly carbon abatement actions, as the marginal cost of abatement of out-of-market mechanisms is much higher than EU ETS carbon price. In the future, such policies must be avoided as much as possible.

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 As confirmed by the study funded by the EU Commission “Carbon Leakage Evidence Project”, 23 September 2013 http://ec.europa.eu/clima/policies/ets/cap/leakage/docs/cl_evidence_factsheets_en.pdf

³ By ‘overlapping’ / ‘out of market’ policies, we mean those that have the effect of reducing carbon emissions in ETS sectors but not as a direct result of the carbon price signal within the ETS. Such policies may be enacted at EU or Member State level, and include (but are not limited to) the 2020 Renewable Energy Target, the Energy Efficiency Directive, and the UK’s Carbon Price Support.

To address this persistent problem and to ensure that it does not continue to undermine the scheme into its fourth phase, **EFET believes there is a number of ‘no regret’ actions that the Commission should employ, as a matter of urgency:**

- Carbon savings expected to arise from ‘overlapping’ policies should be transparently identified, assessed and duly accounted for in setting of the cap for Phase IV.
- The governance framework for the Energy Union should be strengthened to ensure that Member States work *in unison* with the Commission in ensuring the centrality of the ETS, and do not undermine it.
- To the extent that further instances of overlapping policies (specifically at the national level), may be somewhat unavoidable, we believe the parameters of the MSR should be strengthened in order to ensure it is able to withstand such potential supply ‘shocks’. In particular we deem the current withdrawal rate to be insufficient, and recommend that it is increased at the earliest opportunity.

We believe these actions to be of utmost importance for the future functioning of the EU ETS.

In addition, we believe that there are other policy options that warrant further consideration by the Commission, that could improve the functioning of the scheme and make it more robust. These include:

- Consider creating Commission guidelines for Member States on out-of-market policies.
- Consider moving to a shorter (5-year) trading phase.
- Consider setting caps on a ‘rolling’ basis.

Introduction

The market for EU Emission Allowances (EUAs) is oversupplied by more than 2.1 billion EUAs. The European Commission expects this surplus to rise by up to 2.6 billion EUAs by 2020. A variety of factors have led to this situation and, in this instance, overlapping policy measures are an important factor. They have substantially contributed to the surplus, which continues to increase. The surplus has prompted a prolonged period of low EUA prices where the EU ETS has provided little signal for investment in low-carbon technologies.

We see overlapping policies still having a major impact on the EU ETS and leaving little space for market-based investment in low carbon technologies as most of the carbon reductions implied by the cap will be ensured by out-of-the-market measures and the structural decrease in energy intensity.

The Impact Assessment may serve as a good example to underline this fact. In the Impact Assessment, for the 40% GHG reduction scenario, the Commission assumes a 26.5% share of RES and 25.1 % of energy savings until 2030. In fact, both RES and energy efficiency targets for 2030 are more ambitious with goals of 27% each: this difference in the assessment's assumptions would cause further carbon reductions outside the EU ETS in the 2021-2030 period than what the Impact Assessment foresaw. If not avoided, this continuous non-price related downward pressure on the EU ETS demand-side, , will prevent any market-based energy transition from taking place and will not allow the EU ETS to become "central to the EU decarbonising efforts", as pledged by all EU Member States in the October 2014 Agreement.

'No regret' actions to be taken as a matter of urgency

EFET believes there are at least three 'no regret' actions that the Commission should employ, as a matter of urgency:

1. Emissions savings that are expected to arise from 'out of market' policies should be transparently identified, assessed and duly accounted for in setting of the cap for Phase IV.

EFET believes that tackling the lack of transparency is a necessary first step to build a well-functioning and robust market. Systematic and periodic monitoring of impacts and transparent publication of information are key to ensuring market confidence and well-informed decision-making: in particular, more transparency and timely publication of all fundamental data at all levels is needed.

Members States and the European Commission still fail to provide detailed fundamental assumptions at local or aggregated level, particularly on economic growth (GDP growth) and carbon intensity (emission per unit GDP). This was criticised in the recently published Report from the European Court of Auditors. Member States also fail to provide information on the impact that proposed national plans would have on the EU ETS.

The 'lesson learned' from the 2020 EU energy and climate framework is that RES deployment, energy efficiency measures and international offsets *were not duly taken into account* in the cap setting in the past. This has been a major contributing factor to the accumulation of the surplus.

A proper quantitative examination of overlapping impacts is needed before the Phase IV legislative framework is approved. EFET calls EU policymakers and legislators to instigate a **serious qualitative and quantitative re-evaluation of the extent and anticipated impact of overlapping policies as a matter of urgency in the coming months.**

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 IV. **EFET believes that ex-ante revaluation to the cap should be based on**

the expected impact on carbon emissions of out-of-market policies as measured by EC Impact Assessments and national plans reported by Member States to the European Commission.

This should be done ex-ante before the start of Phase IV following consultation with market participants in order to enhance transparency and predictability. The submission of final national energy and climate plans in 2019 and the 4th State of the Energy Union including their first aggregate assessment appears to be the suitable occasion to propose such an adjustment.

Nevertheless, we stress that **ex-post adjustments to the cap or volumes during and after Phase IV must not be applied**. The only exception to this stance can be the Market Stability Reserve (MSR) which will, in fact, adjust volumes during Phase IV, but as a result of an ex-ante agreed mechanism. A well-defined set of rules is key to allow market participants to predict the impacts of such adjustments.

Careful impact assessment prior to implementation and regular reviews thereafter should assess the extent to which these other policies achieve the goal of GHG emission reductions and at what cost.

2. The governance framework of the Energy Union should be strengthened to ensure that Member States work in unison with the Commission in ensuring the centrality of the ETS as a mean of achieving carbon reductions

Governance of EU and Member State climate policies will play a key role in addressing the issue of overlapping policies and restoring market confidence into the EU ETS. Because the ETS is a EU-wide market, the European Commission has the duty and mandate to monitor its well-functioning and prevent any distortions, with particular reference to those related to the cross-border effects of national climate and energy policies. **EFET would like to encourage the Commission to take a more active role in addressing such distortions and ensure that no such national policies are approved without being supported by a full impact assessment of their impacts on the EU ETS.** The Commission should also provide a minimum set of requirements for the impact assessment. We believe the Commission has sufficient legal tools to require this from Member States and should use its expertise to inform national policy decisions

Overall, the governance framework should prioritise the removal of conflicting signals arising from a weak carbon price on the one hand, and uncoordinated national RES-E support schemes on the other. This is of fundamental importance in the pathway towards the achievement of RES 2030 targets: the European Commission should ensure greater EU-coordination of national measures that would help minimise the level of overlap with the EU ETS and its related costs. EU Member States should gradually remove financial support for RES-E technologies, as they mature, in line with their increasing competitiveness.

3. Strengthen the MSR

We call the Commission to strengthen the MSR at the earliest opportunity, as part of the MSR review process, which is due within three years of the start of the operation of the reserve.

We acknowledge that, with the best intentions on behalf of the Commission, and in spite of governance reform, it may be that further instances of overlapping policies (specifically at the national level) may be somewhat unavoidable. We therefore believe that the ETS should be designed in order to withstand such potential ‘supply shocks’.

EFET warmly welcomes the introduction of the MSR, which represents a significant step forward towards a sound market design. Even though this mechanism was not designed to tackle overlapping policies, and certainly does not provide full protection against their adverse impact on the EU ETS, its introduction may limit the build-up of further policy-induced oversupply.

However, given the size of the existing surplus, the MSR is widely expected to be in ‘full withdrawal mode’ for most of Phase IV, and will not be able to play any meaningful mitigating role until the end of the next decade. We therefore reiterate our request⁴ for a higher withdrawal rate so the existing surplus can be reabsorbed more rapidly. As we argued prior to the finalisation of Decision 2015/1814, EFET believes 33% is a more appropriate maximum withdrawal rate than the current one and could help to accelerate the extraction rate when it is most needed, while slowing it down as we get closer to the target.

Other policy measures for consideration by the Commission

In addition, EFET believes that there are at least three policy options that warrant further consideration by the Commission, that could improve the functioning of the scheme and make it more robust. We believe there are pros and cons associated with these options, which need to be explored in detail by the Commission before implementing (if necessary). However, we see the pros as clearly outweighing the cons at this stage.

1. Consider creating Commission guidelines for Member States on out-of-market policies

Above all, EFET believes that there should be no ‘out of market’ policies that have the effect of reducing carbon emissions in ETS sectors. As noted above, we believe the

⁴ See “[EFET position paper on the European Commission proposal for a Market Stability Reserve](#)”, 20 November 2014

Commission should take a more active role to prevent this, and at the very least ensure that no such policies are approved without being supported by a full impact assessment of their impacts on the EU ETS. The ETS reform is still a few years away in terms of coming to an agreement and a few years more until the agreement translates into visible change; hence, for the interim period, the ETS will remain vulnerable to additional out-of-market policies that will further reduce its credibility as the central climate tool of the EU.

In order to avoid this impact on the carbon market, we believe it could be prudent for the Commission to consider producing a set of guidelines for Member States who are considering 'out-of-market' policies. These guidelines could provide a list of necessary policy tools to pick from to ensure the ETS neutrality of national policies, such as buying back allowances on an annual basis or simply transferring them to the MSR. The objective is to encourage/help Member States to 'ring-fence' the impact of out-of-market policies on the EU ETS, thus preserving the EUA supply and demand equilibrium.

Pros

Guidelines are a useful 'soft' tool that can encourage governments to take a holistic approach when considering out-of-market policies. It could encourage them to 'think twice' before implementing them. Moreover, because they are not legally binding, they are fairly non-controversial, can be published relatively quickly and easily, and can potentially achieve big results.

Cons

It should be investigated how such an adjustment could work alongside the MSR, as there is a risk of 'overlap' whereby allowances are withdrawn via two different mechanisms. Together, they may only serve to increase the complexity of the ETS. In addition, there is a risk that by publishing such guidelines, rather than deterring Member States from introducing such policies it effectively legitimizes them. Moreover, because the guidelines will be non-binding, there is a risk that Member States will simply ignore them.

2. Consider moving to a shorter (5-year) trading phase

Experience has shown that it is very difficult to predict the future and usually things turn out differently from what expected. In light of this inevitability, we believe consideration should be given to setting the caps on a shorter timeframe. The current draft legislation envisages a 10-year period for Phase IV, 2021-2030. We believe that a shorter trading period – i.e. 5 years – may be appropriate.

Pros

A shorter trading period of 5 years would have the clear benefit of improving the 'accuracy' of cap setting process. In doing so, it will institutionalise a procedure of

continuous progress and reduce the risk of political ‘intervention’ as a ‘quick fix’ in the case of unexpected events (e.g. back-loading). It could work in tandem with the MSR – the 5 year revision would help addressing the anticipated impacts of overlapping policies acting in the medium term, whilst the MSR can address unpredictable and economic swings acting in the short term. Reviews at shorter intervals would be facilitated by the Progress Reports which will be submitted by Member States to the EU Commission every two years, as foreseen in the new governance system of the Energy Union. Also, a 5-year period would also be fully aligned with the 5 yearly reviews and submissions of climate pledges requested by the Paris Agreement under the UNFCCC framework.

Cons

We acknowledge that this option may have some downsides. For instance, a shorter trading period may not provide the necessary certainty and predictability for the market. A longer trading period provides certainty over the level of the cap over a longer period (except if it is disrupted by ‘quick fixes’ as described above). ‘Locking in’ the cap over a decade could reduce the political influence in changing the cap - provided any further political intervention is prohibited once the cap has been set.

3. Consider setting caps on a ‘rolling’ basis

EFET has looked with interest at the ‘rolling cap setting’ foreseen in the (short-lived) Australian ETS. Under this scheme, annual caps are set and fixed for five years ahead and extended by one year each year.

Pros

The advantage of this solution over a rigid allocation schedule determined over 10 years is that the cap is set and fixed for a sufficiently long period (in this case 5 years), but there is some flexibility to account for unanticipated out-of-market policies and other events on an annual basis when extending the cap by one year. Such a process could be designed to align with the periodical ‘stocktaking’ foreseen by the Paris Agreement from 2023. The combination of stability and flexibility offered by this solution are evident.

Cons

It should be explored in detail how such a mechanism could work alongside the MSR, to avoid adding complexity to the EU ETS architecture; furthermore, as above, the adoption of 5 year rolling caps would not allow to set clear long-term milestones for the traded sector, and hence could weaken the EU’s ability to set long-term targets based on common ‘target years’ agreed at the EU/UNFCCC level.

Conclusions

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.

However, we believe that some additional work is needed to restore the centrality of this instrument: in particular, we believe that the negative effects of overlapping climate policies should be tackled with matter of urgency before the start of Phase IV. 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.

We therefore call on EU institutions to undertake the 'no regret' actions described in the paper and evaluate the policy measures that we have suggested. We are available to discuss these ideas further in details and we remain committed to working for a strong EU ETS.