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Committee on the Environment, Public Health and Food Safety (ENVI) draft report on the 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

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EFET comments – 21 June 2016

General comments

The European Federation of Energy Traders (EFET) would like to offer its views on the Committee on the Environment, Public Health and Food Safety (ENVI) draft report on the EU ETS reform proposal set by the EU Commission.

EFET strongly supports the central role of the EU ETS in the European Climate policy. Europe needs a cost-efficient decarbonisation of its economy through a unique, EU-wide robust price signal for investing in low-carbon technology. This is also needed to implement the 'polluter-pays' principle and to help phase-out the subsidisation of renewable energy sources.

We are firmly convinced that a reformed EU Emission Trading System will deliver the objectives of the EU energy and climate policy whilst reducing carbon emissions in a cost-effective manner across the whole economy. However, today's reality is that the EU ETS is drastically oversupplied, resulting in a prolonged period of low EUA prices. Arguably, the EU ETS now plays a residual role in decarbonisation.

In our view, the highest priority of EU policymakers and lawmakers is **to restore the supply/demand balance of certificates in the market.** As a matter of priority, the reform should address the huge oversupply of EUAs which has arisen from a lack of consistency between the EU ETS as a cap-and-trade system on the one hand, and other climate policies (such as renewable energy, energy efficiency promotion schemes) on the other hand. Without an ambitious reform and the rapid removal of the existing surplus of allowances from the market, there is a risk that market confidence will sharply decrease and price signals will further collapse, thus directly threatening the future role and the very existence of the EU ETS.

We believe that parts of Mr Duncan's proposals are leading in the right direction. As set out in our discussion paper published on 18 January 2016[1], EFET remains convinced that **the best way of tackling the current oversupply and return to scarcity is to strengthen the Market Stability Reserve (MSR)** as soon as possible. We believe that in order to absorb the surplus efficiently, the maximum withdrawal rate should be increased to 33%. This would help to accelerate the extraction rate when it is most needed, but also slow it down, as we get closer to the target.

Below, we have provided our comments on specific points or amendments presented in the draft report.

Consistency between EU ETS and other EU and national climate policies

EFET is pleased to see that the need to ensure consistency between the EU ETS and other climate policies is acknowledged in the draft report. It is to the detriment of EU consumers that the central role of the EU ETS is now at risk. The introduction of 'out of the market' or 'overlapping' climate policies has directly undermined the effectiveness of the carbon market by reducing demand for energy and EUAs, thus acting as a 'substitute' to the EU ETS.

Above all, EFET believes that there should be no 'out of market' policies with the potential to reduce carbon emissions in ETS sectors, without them being fully taken into account in the EU ETS. Consequently, we believe that the governance of the EU ETS should be strengthened and that the EU Commission should take a more active role in preventing and addressing the distortions caused by overlapping policies. At the very least, the EU Commission should make sure that no national policies are approved without being supported by a full assessment of their impact on the EU ETS.

[1] 'Tackling overlapping policies with the EU ETS', EFET discussion paper, 18 January 2016.

We warmly welcome the proposal of amendment n.25 under which the EU Commission shall submit a report every year to address the interaction of the EU ETS with other Union climate and energy policies, including how those policies impact the supply-demand balance of the EU ETS. Moreover, we strongly agree that the EU Commission should be entitled to make a proposal to tackle the effects of overlapping policies undermining the effectiveness of the EU ETS, as proposed at amendment n.78.

However, in our view the Commission should undertake this study as soon as possible, as the effects of overlapping policies are already evident within Phase III. One of the lessons learnt 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 of EUAs during Phase III. Therefore, a proper quantitative examination of overlapping policies' impacts is needed before the legislative framework for Phase IV is approved.

EFET calls EU policymakers and lawmakers to instigate a **serious qualitative and quantitative re-evaluation of the level 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.

Early retirement of generation capacity

We believe the amendment n. 24 of the ENVI Committee draft report is moving in the right direction towards making Member States more responsible for their actions within the climate and energy fields. In fact, measures for early closure of power plants can have a significant impact on the energy market and EUA prices. As a result, Member States need to consider the importance of the EU ETS as part of the integrated power market design and of the integrated EU climate and energy policies. We believe that, at the very least, **Member States should publish an impact assessment of the effects of their national climate policies on the ETS regularly** in order to provide greater transparency of non-ETS national policies.

In the event of the early retirement of generation capacity, the proposal allowing Member States to surrender a corresponding volume of allowances and place them into the MSR would help create more responsibility and awareness of the consequences of national initiatives impacting the European carbon market. It could be considered to make this provision more stringent, placing a requirement on Member States to surrender these certificates. In any case, this proposal should seek to preserve market stability and predictability and needs careful consideration, as there are pros and cons. The triggers of such a mechanism and the methodology used by the EU Commission to calculate the equivalent number of allowances that these closures represent should be clearly established ex-ante in order to avoid unpredictable outward flows of allowances. Considering that an additional withdrawal mechanism working alongside the MSR could increase the complexity of the EU ETS, we believe the transfer of allowances to the MSR would be a less extreme alternative to a complete removal, as previously suggested by Mr Federley in the ITRE Committee draft opinion on the EU ETS reform.

The share of auctioned EUAs should not be reduced

EFET understands that in case the cross-sectoral correction factor is activated, up to 2% of allowances to be auctioned by Member States should be used to mitigate the impact of the shortage of free EUAs. We stress the importance of transparency and predictability in any allocation methodology for both free and auctioned allowances. In our opinion, this would risk creating uncertainty regarding the volume of allowances to be auctioned, and hence non-market based volatility in the price of EUAs.

Moreover, EFET believes that the auctioned vs. free allowances balance should remain untouched, with the ultimate goal being the full auctioning of allowances. In our view free allocation should be considered as a transitional and temporary measure: full auctioning is required to ensure efficient price discovery, and the transition to a low carbon economy at the lowest cost to society. Therefore, as the lowest cost carbon abatement options are deployed over time, 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.

Free allocation should be better targeted

EFET believes that the use of free allocation to compensate for direct costs to industrial sectors that are at risk of carbon leakage is necessary to provide sufficient protection to exposed sectors. However, we support a more targeted approach to free allocation, which should be granted only to companies and sectors that are actually threatened by carbon leakage. In our view **sectors and sub-sectors with low or insignificant exposure to the risk of carbon leakage should not be allocated allowances free of charge for the period up to 2030.**

Also, we stress that the volume of allowances available to carbon leakage sectors must be explicitly defined ex-ante and not be subject to ex-post adjustments, as this would create uncertainty with regard to the available auctioned volumes with consequences for market liquidity and price volatility.

An institutionalised review of the cap in line with the Paris Agreement would be beneficial

EFET welcomes the amendments n. 4 and n. 79 according to which a revision clause should be laid down to allow the EU Commission, where appropriate, to propose an adjustment to the linear reduction factor after the first stocktaking exercise under the Paris Agreement in 2023.

EFET believes that any review process of the LRF or of the cap should be institutionalised in order to reduce the risk of political 'intervention' as a 'quick fix' in response to unexpected events. This could be done by **moving to shorter trading periods of five years,** which would have the clear benefit of improving the 'accuracy' of the cap setting process. A five-year period would also be fully aligned with the reviews and submissions of climate pledges requested every five years by the Paris Agreement under the UNFCCC framework.

Unallocated phase III allowances should be kept off the market

EFET understands that 150 million unallocated allowances will be re-directed to the Innovation Fund and be reserved for innovation in low-carbon industrial technologies and processes. While this is preferable to the option of releasing them to the market via auctions or free allocation, our position is that **these allowances should be kept off the market,** and hence cancelled or transferred to the MSR.

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 impact of their inclusion on the EU ETS balance is well-understood, managed and published.

At the same time we also suggest extending the ETS scope to small emitting installations: therefore, we do not share the proposal to increase the opt-out threshold for small emitters to 50,000 tonnes of carbon dioxide equivalent a year.