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Emissions Trading

Lets throw the ETS a life jacket

The European Emissions Trading Scheme (ETS) has been malfunctioning for months as the low carbon price continues to undermine, rather than encourage, green investment. This will be a central topic during the discussions that the Environment Council will hold on Friday. On Wednesday morning, Green MEP Bas Eickhout addressed the Argus European Emissions Markets conference in Amsterdam and laid bare the challenges such a low carbon price presents, both in the short and long term.

Essentially, if investors believe that the carbon constraints are here to stay and will be significantly tightened in the future, they will invest in climate friendly technologies. However, the current rate at which the cap on emissions is reduced is too low, and the belt needs to be tightened in the short term.

With our economies in the doldrums, this alone will not be enough. The economic crisis has reduced the demand for CO2 allowances and created a surplus that threatens to drown the ETS over the longer term. The only thing that is keeping the scheme afloat is the possibility of intervention: of allowances being set aside.

It is not too late to patch some of the design faults in the ETS and to throw our flagship climate instrumment a life jacket.

Speech text in full:

Europe´s emission trading system is the first of its kind: the biggest carbon trading scheme covering 11,000 power stations and industrial installations in 30 countries. It is our flagship instrument to reduce Europe's greenhouse gas emissions and avoid dangerous climate change. But Europe´s ETS is in trouble, that much anyone can see. The problems with our climate instrument are stemming from a confidence crisis exacerbated by a lack of political commitment. Failure of politicians to restore confidence in the cornerstone of our European climate policies have led to desperate pleas from investors and carbon traders to fix it. The EU's Emission's Trading System is "dead" and "bust" according to Johannes Teyssen, chief executive officer of E.ON. Even companies like Shell have called upon the EU to strengthen its emissions trading system to help carbon prices recover from a four-year low and encourage investment in green technologies.

Due to the depressed economy, the EU's CO2 emissions are much lower than expected when the climate

emission reduction objectives were set. The production of industrial sectors has been below pre-crisis trend levels by more than 10% for over three years. Since our cap-and-trade system has a fixed supply, the reduced demand for CO2 allowances has resulted in a significant fall in the CO2 price. From a price of around 25 Euros per ton CO2 in 2008 it plunged to as low as 6.50 Euros at the beginning of this year. Deutsche Bank expects the CO2 price to remain below 10 euros per ton into 2013 and beyond and estimates that even by 2020 there will be a surplus of allowances, a surplus that will not turn into a deficit at any time beyond 2020 either. Failure to act will not only affect the third trading period of ETS, but will spill into the period after 2020. I find it a bleak prospect that our emission trading system will not lead to a scarcity of CO2 allowances, and therefore not begin to force emission reductions, in the coming decade and beyond.

The objective of the EU´s emissions trading is to "promote greenhouse gas reductions in a cost-effective and economically efficient manner". This has both a short term and long term perspective. For the period up to 2020 it would mean reaching our 2020-target at lowest possible costs. This masks the fact that over the long term, so up to 2050, an efficient climate change policy will need to accelerate the development and diffusion of new breakthrough technology, spur green innovations and provide incentives for climate friendly investments. If it does not, we run the risk of locking ourselves in carbon-intensive capital stocks. The objective of ETS is therefore also to stimulate the transition to a climate friendly society. And this is why the ETS directive points out that Member States should use at least 50% of the auctioning revenues for climate action, for example to encourage the development of technologies that contribute to the transition to a sustainable low-carbon economy. Those companies that are against any structural improvements of the ETS are not paying attention to this longer-term objective of the system and should therefore not receive any of the revenues.

So yes, a low carbon price, as currently is the case, implies that the ETS is functioning as designed in the short run, since we are reaching our 2020-target in a cost-effective manner. However in the longer run we are faced with a problem since

(one) it becomes expensive to replace the long-lived high-carbon capital stock that was put in place between now and 2020 and

(two) the low carbon price fails to spur innovation in the intermediate term, which may lead to a situation in which the learning curve for breakthrough technologies is too steep to keep ambitious emissions reductions within cost-effective reach.

The low carbon price is an obstacle to achieve our longer term climate objectives in a cost-effective manner and a direct result of our weak 2020 climate ambition and too high ETS cap. It is no surprise that EU´s climate target of -20% climate emissions in 2020 is not on the Commission's cost-effective pathway towards the 80% domestic emissions reduction by mid-century. Of course it does not make any sense to reduce our emissions by only 20% in the first thirty years, so from 1990 to 2020, while doing the remainder 60% reduction in the final thirty years, from 2020 to 2050. "Doing everything later" is not a strategy; it is an excuse of those people and companies that in reality do not want to do anything at all. We should not let ourselves be taken hostage by these short-term interests, but take action to let the ETS function as designed.

If investors believe that the carbon constraints are here to stay and will be significantly tightened in the future, they will invest in climate friendly technologies, perhaps even independent of the current low carbon price. Setting targets for the longer term and providing credible long term policy commitments in which investors have confidence is thus essential.

However the current linear factor with which the cap is reduced each year (1.74%) is insufficient and not in line with our objective to reduce climate emissions with 80 to 95% by 2050. This needs be changed as

soon as possible. If we correct the linear factor as of next year, it should be increased to at least 2.25%, if it is done after 2020, it needs to increase even more. If the longer term domestic reduction targets: -40% in 2030, -60% in 2040 and -80% in 2050 are enshrined in legislation and the linear factor is adjusted to be in line with this cost-effective trajectory, we provide clarity over the long term allowance supply. Clarity that is urgently needed.

But tightening the belt does not solve the problem facing us at this moment: a depressed economy, lower than expected production levels and therefore lower than expected emissions. The economic crisis has significantly reduced the demand for CO2 permits and led to a huge oversupply. The surplus of CO2 allowances is around 1.3 billion today and could reach 2.4 billion allowances by 2020. This surplus allows emissions to grow in the coming years and deters investments in emissions reductions, which will make it harder (and more expensive) for companies to reach the longer term targets. It therefore undermines the overarching objective of the ETS: reducing emissions in cost-effective manner. We should find ways to avoid a big accumulation of surplus allowances resulting from a sudden decline in economic activity. If economic growth is much lower than anticipated, then perhaps the cap should be adjusted as well. Australia for example has proposed a system combining long term security with some short term flexibility. There is a 5-year cap in line with the long term reduction target, but every year the cap for over 5 years could be adjusted based on the advise of an independent climate change authority.

The Climate Markets & Investment Associations (CMIA) has also come forward with a proposal that I find very interesting. Every year, if a certain number of surplus permits (defined as the difference between the actual emissions and the cap) has not been used after a period of three years, an equal number of permits should be removed from later supply. This stimulates emission reductions in times of a recession, since companies want to hedge against the risk of a sudden carbon price spike in times of economic recovery.

I have not seen the perfect recipe yet, but to avoid future ad hoc and unjustified interventions, we need to think about criteria when an automatic intervention could be triggered.

The current situation in which supply of CO2 allowances structurally exceeds demand is not only due to lower than anticipated demand. How the allowances are allocated to industrial and power sectors has been subject of heavy lobbying in the past and this has also contributed to the situation of oversupply. The third ETS phase will see the transition to auctioning; around 50% of all allowances will be purchased at auction, according to estimates by the European Commission. Due to carbon leakage and competitiveness concerns, the majority of the industry will still receive most of their allowances for free, but from now on according to centralised allocation rules. Free allocation comes at a cost however, it introduces the risk of windfall profits for example and by protecting carbon –intensive sectors it increases the burden on other sectors to achieve the economy-wide target. Auctioning on the other hand keeps the price signal intact: the polluter pays, climate friendly alternatives are encouraged and companies are able to generate financial benefits from low-carbon investments. We need to move towards auctioning, not only for the power sector, but also for the industrial sectors. In the future, sector-specific solutions need to be found to properly address carbon leakage. There cannot be a one-size-fits-all solution to address the risks of relocation and other competitiveness impacts, since every sector that is exposed to competitive concerns has different specific risks. For the aluminium sector, we could think of investment subsidies on a case-by-case basis. For the cement sector, border levelling is an option. The steel sector is one of the only sectors where in the short run allocation of free allowances could address carbon leakage, while working on a better solutions like a global sectoral agreement.

Auctioning is a fair, efficient and less-lobby-sensitive way of distributing allowances. And by increasing the share of allowances to be auctioned, we will also realize more revenues that could be earmarked for supporting demonstration projects and the development of breakthrough technologies.

A last structural deficiency of the ETS that is hindering Europe´s transformation to a climate friendly economy is the amount of offsets allowed. Half of the total reduction effort can be achieved through international offsets. The Clean Development Mechanism was developed to bring sustainable development for developing countries while allowing rich countries to achieve their emission reduction in a cost effective way. But up to now CDM projects have been riddled by scandals and problems over additionality, while reducing the need for European action. Many CDM projects would have been built irrespective of support. Many CDM projects are located, not in the least developed countries, but in China or India. Sometimes European companies are subsidizing their competitors in China through buying CDM credits. CDM should always be supplemental to domestic EU efforts and help the poorest countries progress on their sustainable development path.

Last year, the concerns around the additionality and environmental integrity of certain industrial gas credits have led to the ban of offset credits that destroy industrial gases and this move I applaud. But under CDM new coal fired power plants can still earn CDM credits, even though coal is one of the world's most carbon intensive fossil fuels. Problems are also surrounding CDM credits from large hydro projects; many of these projects are not additional and cause environmental and social harm. The integrity of the offsets that are used within ETS needs to be ensured by setting further quality and quantity restrictions on the use of CDM in the ETS.

Our flagship instrument to reduce climate emissions is still in its infancy days. The extremely low carbon price and large supply of unused allowances that will not be absorbed for years to come are arguably dangerous threats to the credibility of the ETS. A climate instrument that is designed to force emission reductions but will not do so until after 2020 is not a well functioning climate instrument. A market that is supposed to deliver incentives for cost-effective emission reductions in the short, medium and long term but will see record-low carbon prices for years on end, is not a well functioning market. Our current system will not spur innovation, will not encourage climate-friendly investments, will not reward companies for investing in low-carbon technologies and will lock us in carbon –intensive capital stocks. Permanent solutions are needed to align the ETS with our long term targets. We need to increase our 2020 climate ambition, change the linear factor with which the cap is reduced every year, develop mechanisms for automatic interventions in case of prolonged surpluses, move towards full auctioning while proposing sector specific solutions for sectors that are prone to competitiveness concerns and ensure the environmental quality and supplementarity of offsets.

We need to do all this, and soon. The reality however is that these permanent solutions to fix the ETS will *not* happen in the near future. And since many carbon traders and investors are losing confidence in our emission trading system, we need to move forward on an urgent and rapid fix. Setting aside and eventually cancelling allowances is such a second-best solution.

The Energy Efficiency Directive, which is now being discussed by the European Parliament and Council of ministers, could further damage the credibility of the CO2 market in the short run since its adoption would lead to additional energy savings and a further decline in demand for emissions allowances. When the Commission proposed the draft Energy Efficiency Directive in June 2011, the CO2 price fell 20%. In the ENVI opinion to the leading energy committee of the Parliament I tried to and succeeded in getting a majority in favour of withholding and cancelling 1.4 billion allowances. The day of the vote, the carbon price rose 30%, but unfortunately only temporarily. At the end of last month also the leading energy committee took the set-aside issue on board and called upon the Commission to take the appropriate measures to fix the ETS. In other words: the Parliament is calling –loud and clearly- upon the European Commission to amend the auctioning regulation in order to set-aside a significant amount of allowances. A majority of Council and Parliament would need to be against this amendment in order to oppose such a move. The Commission needs to propose this amendment swift, before the end of this year, since the third trading period starts next year and ex-post adjustments will be heavily opposed.

The amount of allowances to be set-aside also needs to be determined by the Commission. I have called for withholding an amount of 1.4 billion allowances, but it could be even more. The Commission estimates that there will be a surplus of up to 2.4 billion allowances by 2020. And we would need to decide later (by co-decision) what to do with these allowances that are set-aside. Ideally, the set-aside allowances would be cancelled permanently.

The possibility of such a recalibration is the only reason why the carbon price is still floating. This intervention needs to be clearly explained as a one-time-only measure, to avoid future pressures for loosening the cap in times of economic booms. The ETS is a learning-by-doing system, it is not yet established as a credible and fully functioning climate instrument. And sometimes we find design faults that were not foreseen when drafting the legislation. It should never be too late to correct for these beginner mistakes. If the ETS is here to stay we should, by all possible means, put an immediate stop to the accumulation of surplus allowances that are threatening to undermine the whole purpose of our emission trading system: reducing greenhouse gas emissions. Let´s throw our flagship climate instrument a life jacket before it drowns in its surplus allowances.

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