



Report on the State of the European Carbon Market

3 December 2012



State of the carbon market

- *Liquid and technically functioning well.*
- *From 2013 onwards fundamental architectural changes to harmonise the ETS.*
- *Emissions decreased by more than 10% since 2008, in part due to the economic crisis.*
- *Macro-economic circumstances give rise to the build-up of a surplus close to 1 billion allowances end 2011.*



State of the carbon market

- *In 2012 and 2013 rapid build-up of this surplus, largely due to regulatory provisions in the transition of phase 2 to phase 3.*
- *By end 2013 surplus could be well over 1.5 billion allowances, and even as large as 2 billion allowances.*
- *Net demand in 2013 decreases because hedging demand beyond auctioning is expected to drop away.*
- *Surplus continues to grow, and will reach for most of phase 3 up to 2020 a size of around 2 billion allowances.*



The challenge

- *The ETS Directive aims to promote reductions of GHG in a cost-effective and economically efficient manner. This aim is not limited in time.*
- *The ETS is designed to be technology neutral, cost-effective and fully compatible with the internal energy market.*
- *But the size of the surplus negatively affects investment incentives in the ETS.*
- *The ETS needs to play an increased role in the transition to a low-carbon economy by 2050.*

Two step approach

First step:

- *Address the challenge in short term*
 - ⇒ *postponement of auctions of 900 million allowances ("backloading") – separate track*

Second step:

- *But backloading won't address structural problem, so "structural action" required*
 - ⇒ *Carbon market report starts a discussion that looks into 6 possible options for such action.*

Options for structural measures

Option a: Increasing 2020 target to -30%

Option b: Retirement of phase 3 allowances

Option c: Early revision of linear factor

Option d: Include other sectors in the ETS

Option e: Limit access to international credits

Option f: Discretionary price management



A: Increasing 2020 target to -30%

- *If the conditions are right*
- *Change the quantity of allowances through*
 - permanent retirement
 - or revision of the linear reduction factor
- *this requires a reduction in volume by 2020 of 1.4 billion allowances*
- *Increased ambition level would also apply to non-ETS sectors and affect the targets under the Effort-Sharing Decision*



B: Retirement of phase 3 allowances

- *Retires phase 3 allowances through reducing auction volume*
- *Can be done via a self-standing Decision, thereby leaving the wider regulatory framework unchanged.*
- *Realigns ambition before 2020, but not afterwards.*
- *Direct contribution to achieving RES and energy efficiency targets.*



C: Early revision of linear factor

- *Directive foresees this to be done as from 2020 with decision to change by 2025.*
- *This could be advanced.*
- *Would affect both pre and post 2020 ambition level.*
- *If wanted can be set in line with 2050 milestones*
- *Other important policy questions need to be addressed*
 - increase EU's low carbon technology competitiveness
 - link with international carbon market
 - risk of carbon leakage



D: Include other sectors in the ETS

- *Emissions in non ETS sectors were less prone to macro-economic swings => more stable demand*
- *Also in the longer term, changes in the non ETS will impact the ETS, e.g. electrification of transport*
- *Depending on the cap set, ambition level can increase and thus surplus can be absorbed.*
- *Other important policy questions need to be addressed*
 - *Who has compliance obligations?*
 - *How would it relate to other policies impacting these sectors?*



E: Limit access to international credits

- *International credits allowed to contain compliance costs, but have become major driver of the surplus.*
- *Limiting future access to credits would lower risk on major renewed surplus build up in the future*
- *Investment clarity on real domestic effort needed*
- *Flexibility could be allowed in times of demand shocks*
- *To be balanced against:*
 - *Lower financial and technology flows to developing countries.*
 - *If international conditions are right and the cap would be strengthened, how to use as cost containment.*



F: Discretionary price management

- *Adjust auction supply so that prices are maintained at minimum level:*
 - Auction price floor
 - Reserve that sees inflow of allowances if there is a large temporary supply-demand imbalance and vice versa
- *Major change to a quantity-based mechanism.*
- *Risk on politics deciding on price level not the market, governance questions need to be addressed.*
- *If set too low, ineffective.*
- *If set too high it fixes the prices (no flexibility).*



Option	Effects supply/demand	Speed of deployment	Changes ambition post-2020	Impacts free allocation
a. Increasing the EU GHG target to -30%	Supply	Depends on mechanism	Depends on mechanism	Depends on mechanism
b. Retiring a number of allowances	Supply	Relatively fast	No	No
c. Early revision linear reduction factor	Supply	Slow	Yes	Yes
d. Extension of the scope	Demand	Slow	Depending on design	No
e. Access rules to international credits	Supply	Slow	No	No
f. Discretionary price management	Supply	Slow	No*	No

*Assuming that the mechanisms would not result in the cancellation of those allowances that are temporarily not auctioned.

- ***Commission will shortly launch a public consultation***