Strengthening the EU ETS:

Creating a stable platform for EU energy-related investment

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Climate Strategies

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PART I: EU ETS Objectives and recent evolution

PART 2: The Options - Overview

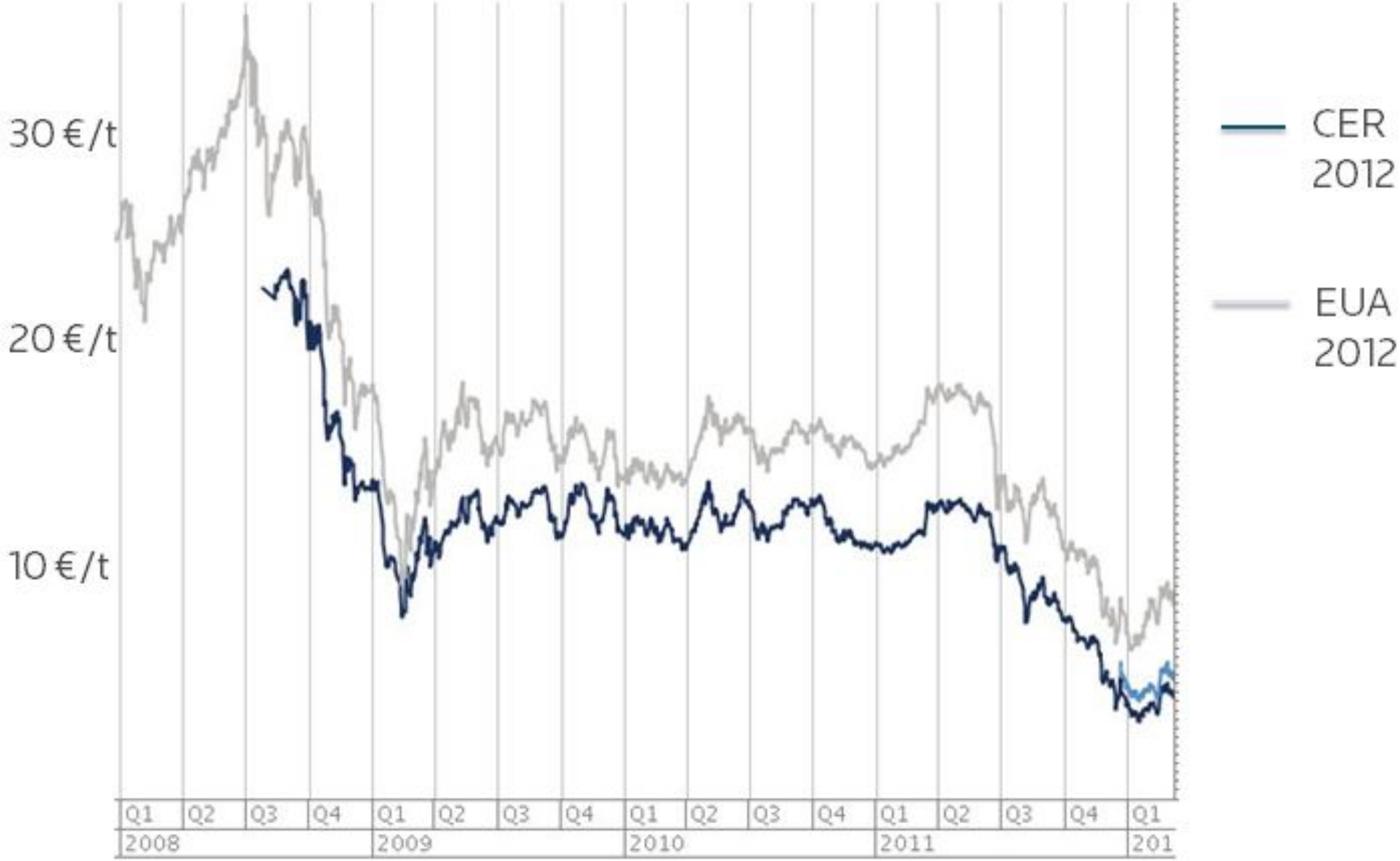
PART 3: An integrated and international perspective

Recommendations

Annex on the specific options

& some economic characteristics

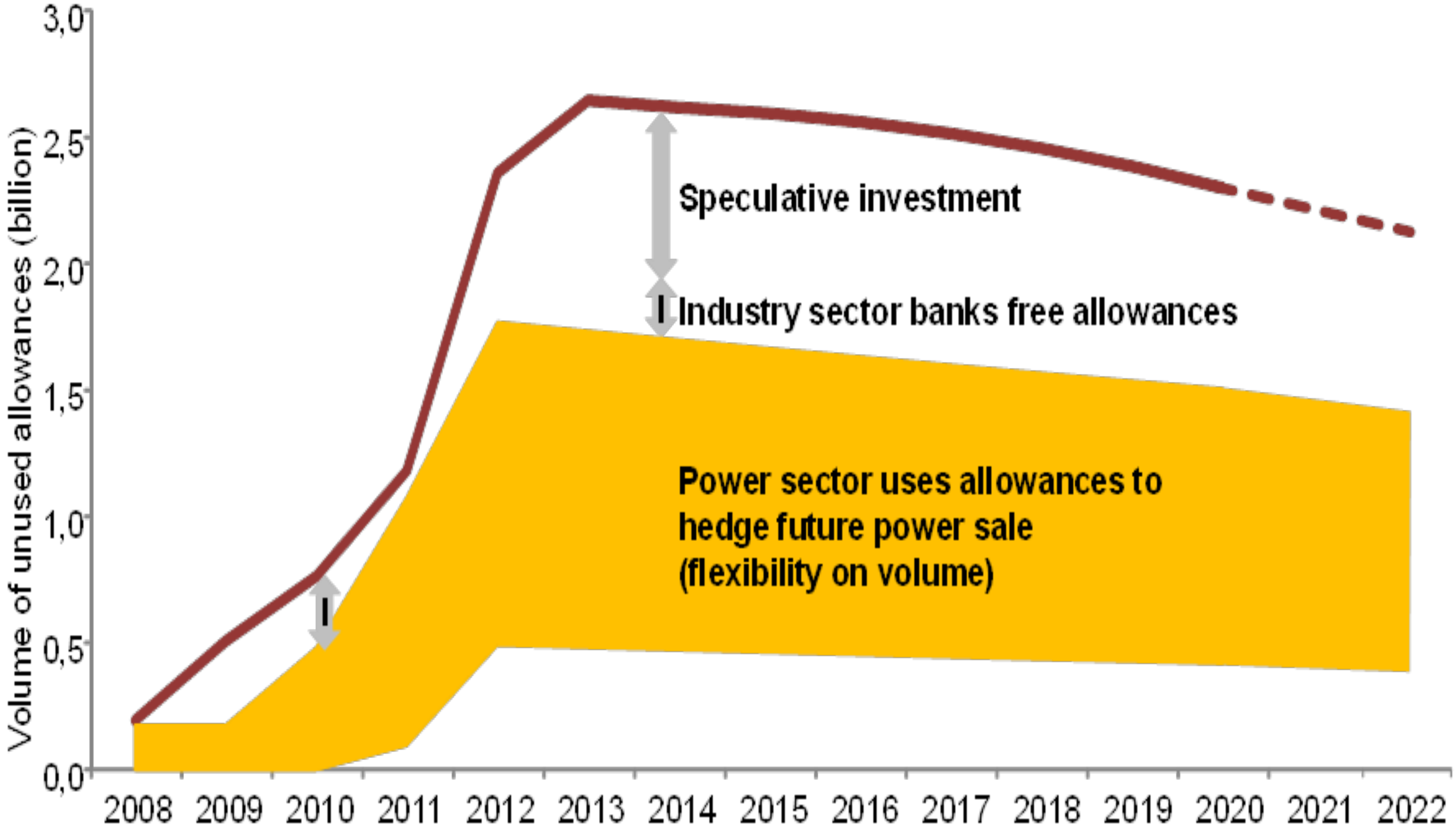
EU Emission allowance and credit (CER) prices, Phase II (2008 - Feb 12)



… First, *be clear about the causes and what makes this a problem*

Proximate cause: accumulated >2GtCO2 surplus

.. that takes us outside plausible zone of post-2020 banking



Source: Neuhoff et al, Banking of emissions allowances – does the volume matter? DIW Berlin

Objectives of EU ETS

Primary objectives:

- Deliver an environmental objective efficiently (price mechanism) at a negotiated balance of acceptable cost
- Influence corporate investment towards low carbon investment

Secondary objectives:

- Contribute to EU's international commitments in assisting developing countries (eg. CDM)
- Raise finance including to support low carbon innovation (eg. NER 300)

Minimise conflict and maximise synergies with complementary policies

See also CEPS report (forthcoming) for official statements

Impact on primary objectives

Deliver an environmental objective efficiently (price mechanism) at a negotiated balance of acceptable cost

- Near-term cap delivered
- Efficiency undermined by uncertainty and price inconsistency with science-compatible long term pathways
- Balance of quantity and cost entirely different from that originally negotiated

Support low carbon investment

I. *Capturing Companies' Attention* – still relevant
II. *Providing Clarity for Decision Making* – little or none
III. *Creating enabling environment for Low-Carbon Investment* – little or none

Impact on secondary objectives
- set in macroeconomic & international context

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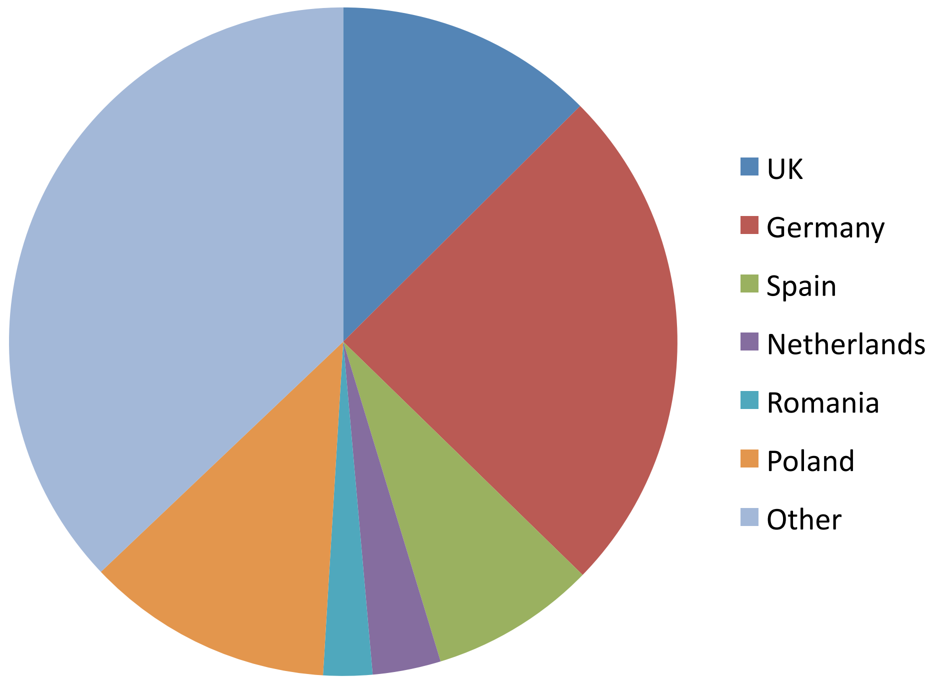
- EU needs investment – including heavy investment in energy sector (many hundreds of €bns over this decade)
- Fiscal crisis has not gone away, weakens EU economic recovery and international standing; expected ETS **revenues**, to be shared between general, energy & international climate expenditure, were not trivial!

	In 2013 (@ €15/ tCO_2)	In 2020 (@ €22/ tCO_2)
EU-27	**€ 19 billion**	**€ 27 billion**
Germany	€ 5.1 billion	€ 6.8 billion
UK	€ 2.6 billion	€ 3.4 billion
Poland	€ 1.6 billion	€ 3.3 billion
Spain	€ 1.6 billion	€ 2.2 billion
Italy	€ 1.7 billion	€ 2.4 billion
Greece	€ 0.8 billion	€1 billion
Netherlands	€ 0.7 million	€ 0.9 billion
Romania	€ 150 million	€ 650 million

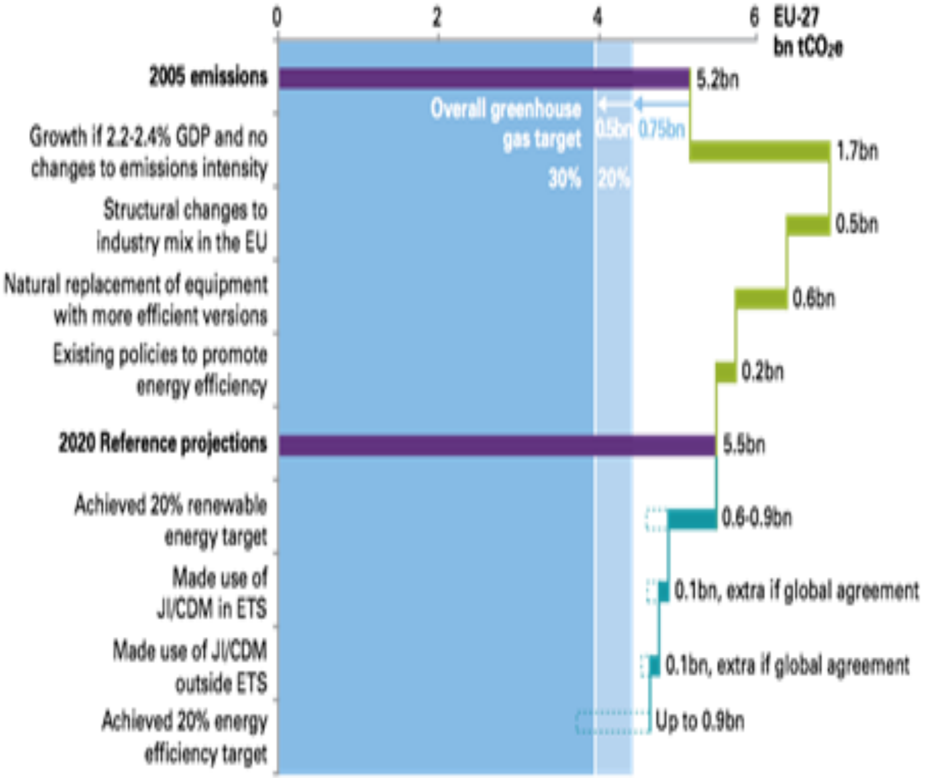


Distribution of cumulative revenues between countries (EU total (2013-20) = €182bn)

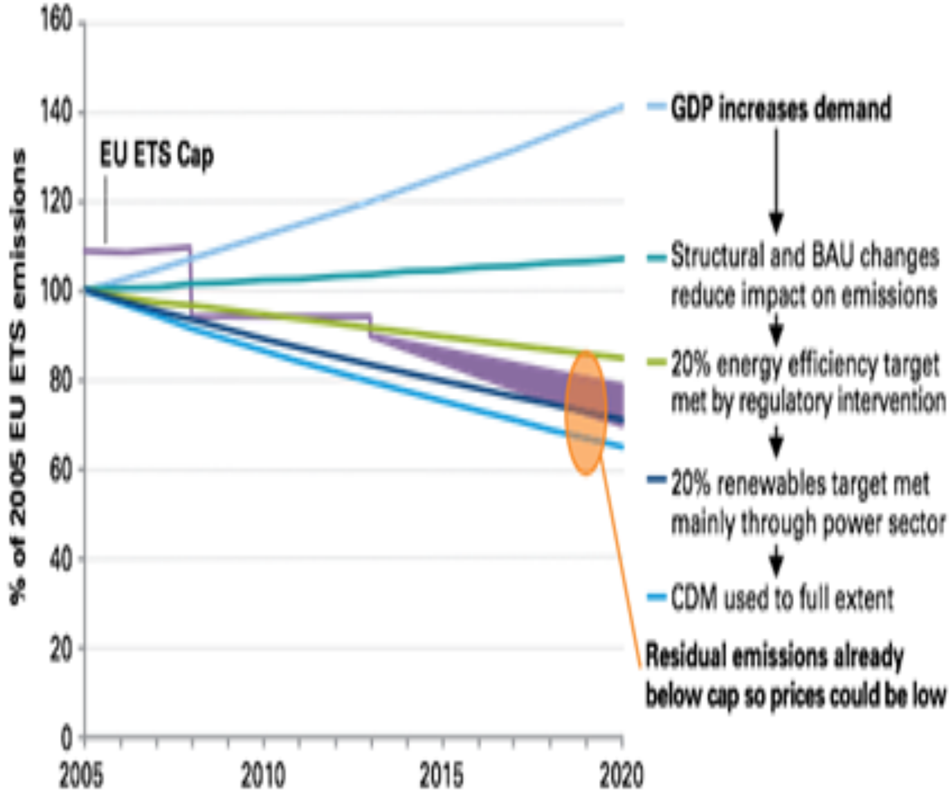
Is intervention *justified?*

Recession is a plausible basis for *force majeure*, ***also*** original deal inconsistent with complementary measures, reflecting hopes of moving to 30% ..

(a) Potential factors influencing EU emissions by 2020 including energy efficiency and renewable energy targets



(b) Trends to 2020 in 'low demand' scenario *before* any allowance for recession



Source: Carbon Trust (2009), *Cutting carbon in Europe: the 2020 goals ..*

Yes, But …

Any intervention needs to

- Be clearly linked to specific objectives
- Learn from the past
- Acknowledge intrinsic uncertainty
- Provide for a more enduring and robust framework
- Help link EU ETS to Europe’s wider fiscal and macroeconomic (investment) challenges

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ETS Options

Post 2020 framework is crucial

Negotiating time

Credibility in current markets

Uncertainties in 'getting it right'

Shorter-term quantity measures

1. 2020 EU GHG targets
2. Tightening the ETS cap/trajectory
3. Set-aside allowances

Price-based / reflexive measures

4. Reserve price auctions for the ETS
5. National floor price – domestic corrective mechanisms
6. Other options?

6. Other options

- Government buy-back – a hybrid of coalition and EU measures
- Capped banking – another possible enduring approach
- Carbon Bank – institutional complexities
- …

Not clear advantage but some worth exploring further

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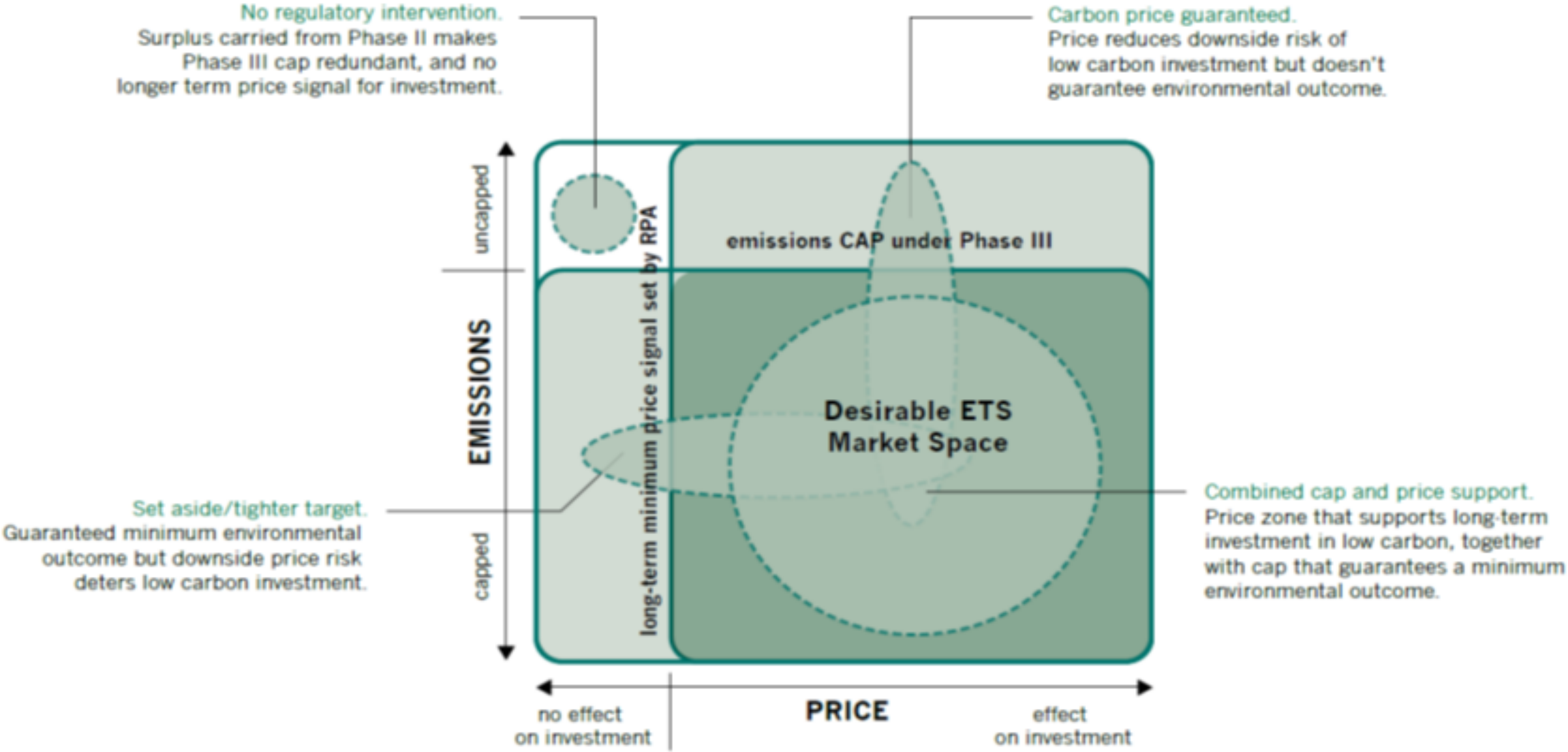
Hybrid (Quantity + price corridor) design has advantages in complex (and uncertain) world



Source: Climate Strategies (2012): Grubb M., 'Strengthening the EU ETS: creating a stable platform for EU energy sector investment', www.climatestrategies.org, March 2012

.. That increases stability and predictability of price (and revenue)

Result of simple "stress test" on EU ETS Phase III prices

	Lowest emissions trend	Central emissions trend	Highest emissions trend
No intervention	Below 5	5 – 10	11-17
1400MtCO_2 Set-Aside	Below 10	20	Above 30
Reserve Price Auction	18.5	18.5	18.5*
Combined Set-Aside with RPA	18.5	20*	Above 30

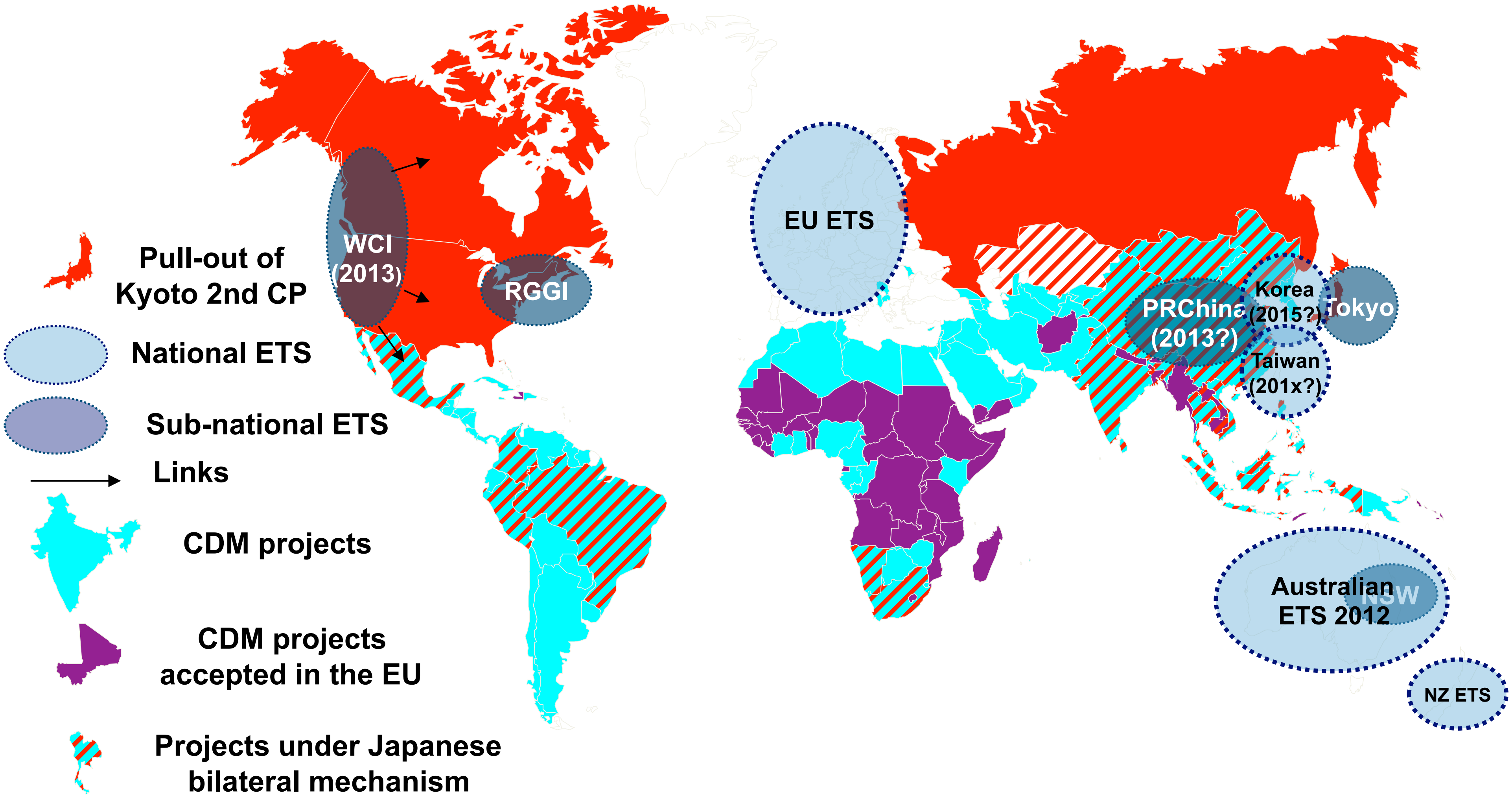
Notes: For assumptions see Annex to CS report on Strengthening the EU ETS

**In cases with an 'open trading' price close to the level of Reserve Price Auction, the actual trading price may be slightly higher than indicated since the RPA would reduce the downside risk to those buying or holding allowances at the prevailing price.*

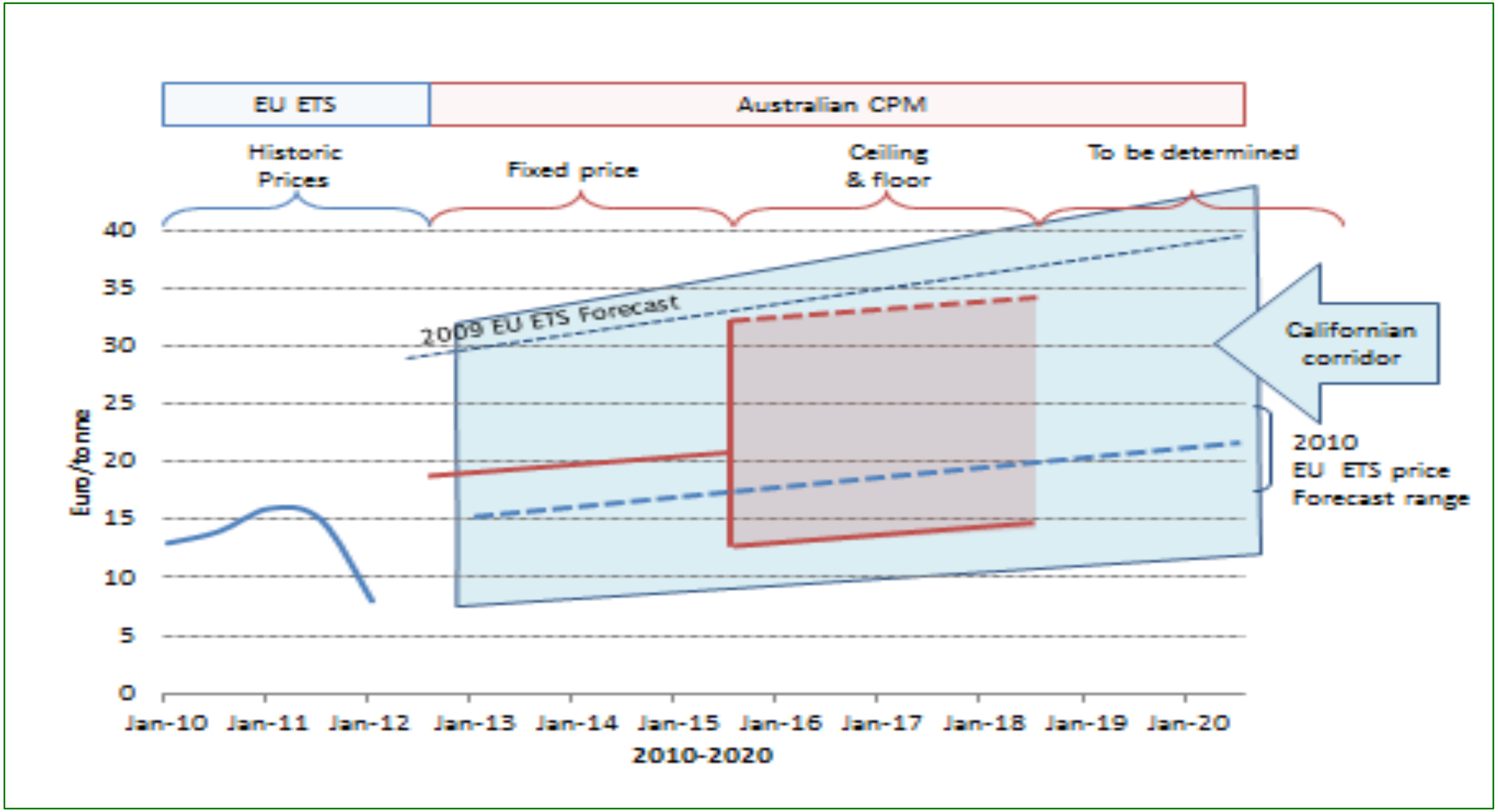
Primary conclusion

- No single option seems adequate
- Need to evolve a triad of responses:
  - Set-Aside to address the current surplus – recalibration
  - Reserve Price Auctions or similar approach to restore confidence and cap downside risk for investors
  - Early launch of post-2020 negotiations
- .. Rooted in an integrated and international perspective

EU policy needs to be set in international context



EU ETS history compared to California and Australia systems



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Core recommendations

- Set-Aside is ‘necessary but not sufficient’
- Negotiations on post 2020 framework needs to start urgently but cannot solve the problems of present price and credibility
- Reserve Price Auctions (or similar) a valuable complement
  - Key debate about legal and procedural dimensions of adopting them in Phase III or Phase IV
  - Has many parallels to legal and procedural dimensions of Set-Aside
- The combination creates a more robust system for the future and gives legitimacy and credibility to a one-off ‘Recalibration’ Set-Aside that is otherwise lacking
- Do / which interventions require renegotiation of the Phase III Directive – in intense political debate
- *Crisis is also opportunity to learn lessons and establish more robust design – Set-Aside should be springboard for deeper processes*