

EU ETS Restructuring: evolution or revolution?

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Structural reform of the EU ETS

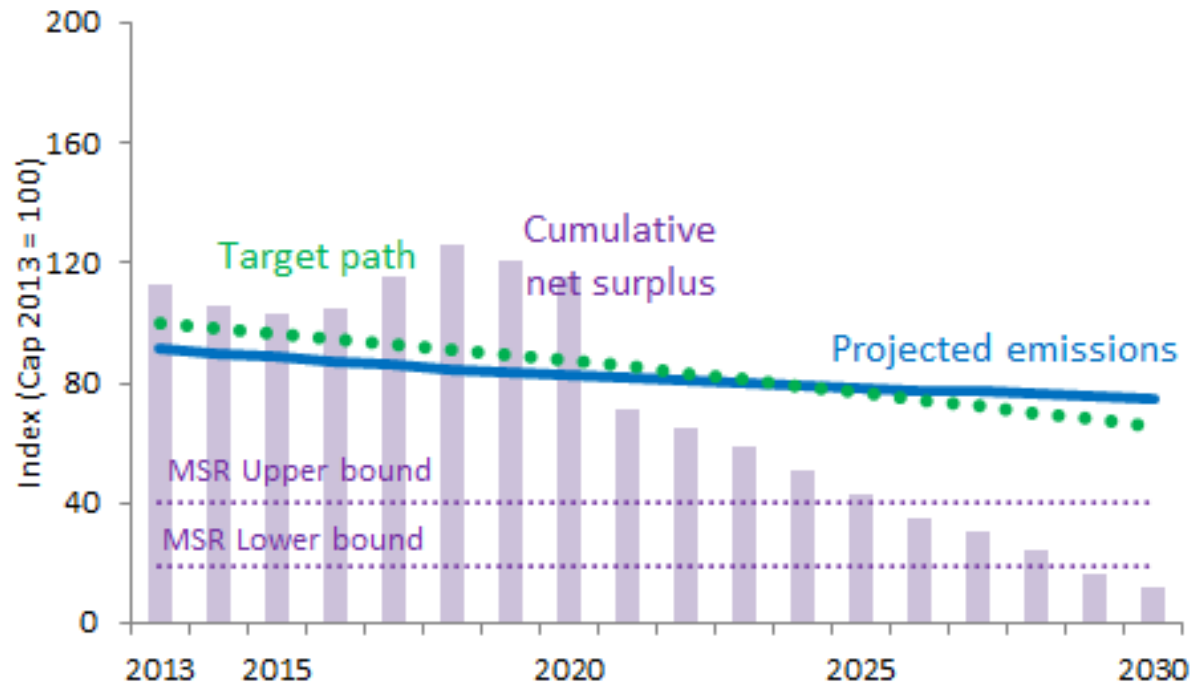
- CEPS, WIFO, the Wegener Center at the University of Graz & the Austrian Environment Agency have worked on an Options Paper, analysing various reform options for the EU ETS: *“Scanning the Options for a Structural Reform of the EU Emissions Trading System”*
- On the basis of the options reviewed, we have put together a comprehensive reform package, which we present today
- We select reform options addressing auctioning rigidity; flexibility in free allocation; and further elements to enhance the ETS’ functionality

Reform 1: addressing auctioning rigidity through the MSR

- Yesterday's trilogue resulted in an agreement on the MSR:
 - 1/1/2019 start
 - Backloaded & unallocated allowances moved straight to the MSR
 - Review by Commission of whether to use up to 50m allowances for industry innovation fund

Reform 1: addressing auctioning rigidity through the MSR

2019 start; backloaded & unallocated allowances to MSR

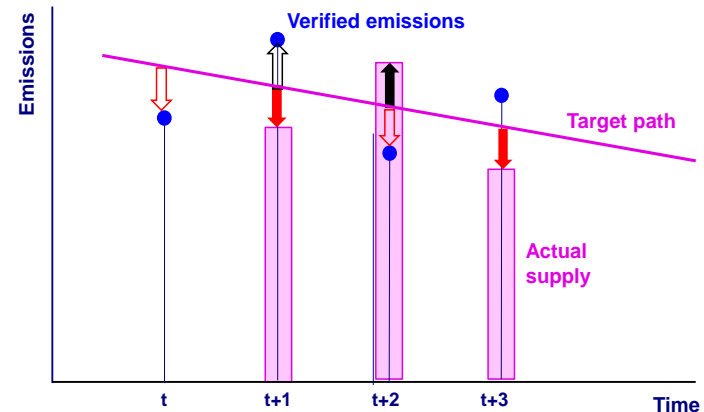
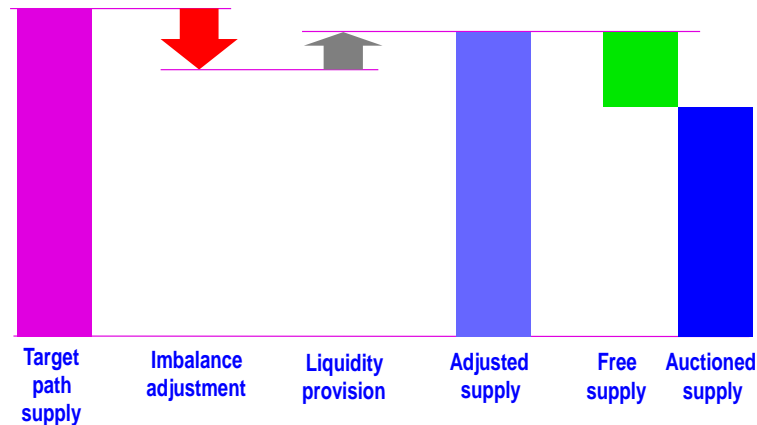


Reform 2: more flexible free allocation & long-term target path

- The rigidity in the current method of free allocation has contributed significantly to the EUA surplus
- Using recent benchmarks & recent activity levels would address this
- We also assume the implementation of the 2.2% Linear Reduction Factor: this creates a target path which creates visibility for the long-term (2050) target and scarcity of allowances *if* trading phases are also abolished
 - Abolishing trading phases would create more certainty and predictability which would be positive for investment decisions

Reform 2: more flexible free allocation & long-term target path

- With continuously updated activity levels, imbalances may fluctuate around a target path, or stay above or below it for extended periods



Reform 2: more flexible free allocation & long-term target path

- For flexible free allocation, we specifically propose an option [2.2.2] which has *partial* flexible allocation, *capped* share of free allowances, and the use of a reserve to compensate for imbalances
 - The difference between the determined (capped) amount of free allocation and the amount of free allocation required on the basis of the dynamic updates to benchmarks and activity levels is compensated for using a reserve like the MSR
 - A correction factor such as the CSCF is no longer necessary
 - The ratio of auctioned volumes vis-à-vis free allocation is kept the same
 - This reform option ticks a lot of the boxes of the Oct 2014 European Council Conclusions

Reform 3: additional elements

Targeted free allocation

- The European Council's guidance, which indicates a desire to shield the most efficient installations from undue carbon costs (both direct & indirect) while taking into account the affordability of energy prices and the avoidance of windfall profits, points toward a more focused way of allocating free allowances:
 - Combine criteria related to trade exposure & emissions intensity, as both are required for there to be a significant risk of carbon leakage
 - Instead of the current binary system, where sectors are either included on the CL-list (and thus eligible for free allocation), the quantity of free allowances allocated to an installation is linked to criteria of trade exposure, process emissions, and indirect carbon costs – this creates a more gradual system of determining carbon leakage risk and removes the need for a CL-list
 - A choice may be made to only cover a certain degree of carbon costs depending on their source: processes, indirect carbon costs
 - Sectoral differentiation may also be considered then

Reform 3: additional elements

Different treatment for indirect carbon costs

- The current system of allowing state aid for indirect carbon cost compensation has significant drawbacks as it based on Member State discretion, awarded only ex-post, limited and tapered over time in coverage, and distorting the internal market
- Two options:
 - A) inclusion of indirect carbon costs as a criteria for determining free allocation
 - B) Auctioning revenues could also be redirected to compensate indirect carbon costs

Reform 3: additional elements

Reformed governance

- The EU ETS Directive – the outcome of many extensive rounds of co-decision – sets many crucial parameters of the EU ETS regarding allocation, the LRF, carbon leakage mitigation et cetera
- With the MSR, auctioning supply-side flexibility will need to be governed with provisions on the bandwidth and withdrawal & reinjection rates
- The backloading & MSR examples show how laborious the current governance system is, and how much uncertainty it creates in the carbon market
- By delegating rule-making powers, the governance of the EU ETS can be made more responsive to changing circumstances – such as, for example, when changes in hedging demand merit changing the thresholds for the MSR
- This could be an independent regulatory agency, or simply the use of existing delegated rule-making procedures

Reform 3: additional elements

- Activating domestic offsets [Art24a] – for domestic project-based crediting
- Different sectoral treatment within the same ETS: the target paths for power and industry sectors could be differentiated
- Different treatment small installations: emissions levy based on energy consumption and average emissions intensity
- Emissions Performance Standard: to speed up power sector decarbonisation – limit CO₂ emissions per kilowatt hour
- Extend sectoral coverage of the ETS: e.g. transport, but also upstream fuel distribution as in California
- Innovation Reserve: use more allowances for innovation projects