

ETS SYSTEM INTERVENTIONS POSITION OF THE ELECTRICITY SECTOR

SUMMARY

STATEMENT

UFE considers the European allowance market as an effective mechanism for supporting reductions in CO₂ emissions in industrial sectors and facilitating the transition to a low-carbon economy at minimum cost. However, for the electricity sector, visibility of the long-term targeted emissions reduction objective is essential. Yet today, the price of carbon, as revealed by the ETS system, is low, which results in players not being given the necessary signal to anticipate their investment towards low-carbon technologies.

UFE believes this can be explained by several factors:

- **Uncertainties surrounding medium- and long-term reduction objectives** and doubt about the sustainability of the system beyond phase 3 (post-2020);
- **A lack of consistency and coordination between the objectives and the linkage of various interdependent public policies regarding energy and climate change;**
- **The strictness of the operational rules** of the ETS system

In such conditions, there is a significant risk that some States may seek to correct the system by pursuing individual and unilateral initiatives, or even that the system itself may be called into question, which is clearly undesirable.

It therefore appears necessary for UFE to rapidly find solutions aimed at strengthening the system.

PREREQUISITES

Before taking up a firm position on one or a combination of any of these propositions, it is essential for UFE to evaluate both their market and carbon price signal impacts, and also to take a more global look at their impacts on the objectives which have been assigned to the system. It is equally necessary to evaluate the potential impact on European electricity prices and the various effects studied for both the wholesale market and the end consumer.

UFE also stresses the need for consistency and coordination of policies surrounding climate change and energy (Energy Efficiency, Renewable energies...); in particular, the need to quantify expected CO₂ emissions volumes savings which may result from the implementation of these policies.

Furthermore, having a harmonised Europe-wide system is an essential part of market liquidity and its proper operation.

Finally, whichever intervention options are decided upon, it is imperative that they be predictable.

Any arbitrary intervention would undermine confidence in the mechanism, with the suspicion that it might be called into question by the public authorities at any moment.

RECOMMENDATIONS

Solutions to be implemented could include a mix of complementary and consistent measures which would be established at different points in time depending on their ease/speed of validation and deployment:

1. *Medium-term measure, requiring rapid initiation: Fixing a binding target reduction objective to phase 4 of the ETS mechanism*

UFE supports a binding target reduction objective to phase 4. This objective must be set as soon as possible and it must be in line with other long term objectives to 2050. To avoid overly-consequential market developments, it would be necessary to ensure smooth objective growth over intermediate points. Such a measure would provide the necessary visibility to allow long term investments and to limit “shocks” due to players’ expectations.

2. *One-off adjustment of allowances volumes*

UFE considers that, **if the proposal of the ITRE Committee which calls for one-off adjustments of allowance volumes were to be adopted, such a proposal should be subject to an impact study.** Moreover, UFE underlines that an intervention on the market should be made consistent with a long-term European CO2 target. UFE strongly believes that a global reflection on the structural methods to be used to adjust allowance quantities should be launched urgently.

3. *A political measure to cope with long-term approach: the creation of an independent European supervisory entity*

UFE is fully aware that implementing a European supervisory entity would require firm political decisions as well as long and complex negotiations. That is why this proposition must only be considered for the medium-term.

However, in order to give the system much-needed credibility, UFE proposes to **immediately work on a possible evolution of the current ETS market regulation and of the surveillance mechanisms.** This reflection should also consider the institutionalization of a supply adjustment mechanism.

PREAMBLE

Electricity producers are amongst the most restricted operators in the effort of greenhouse gas reduction. From 2013, they will be the only ones who must buy 100% of their CO₂ allowance at auction. ETS market operation and its ability to deliver the right signal price therefore constitutes a significant challenge, the likes of which electricians pay close attention.

For UFE, the European allowance market is an effective mechanism for supporting reductions in CO₂ emissions in industrial sectors and facilitating the transition to a low-carbon economy at minimum cost.

An environmental signal can be sent which simultaneously impacts the use of existing production methods and future investment decisions.

To reach these objectives, the ETS mechanism must:

- offer an adequate incentive to invest in assets with few or no carbon emissions;
- and ensure this incentive for the long-term because the electricity sector favours long-term investment choices. Indeed, the large-scale decommissioning and renewal of European power plants which must take effect around 2030 and the decisions which will be taken in the years to come, will condition the structure of the European power system for several decades.

For the electricity sector, it is therefore essential to have good visibility regarding long-term emissions reduction objectives.

Today, the price of carbon indicated by the ETS system is low, meaning that players do not receive the necessary signal to plan their investments in low-carbon technology.

If this level can be explained by the actions of lowering emissions implemented by the slowing of the economy following the economic crisis, it nonetheless also appears to reflect a lack of confidence on the part of the players in the actual efficiency of the system.

According to UFE, this can be explained by several factors as listed below:

Uncertainties surrounding medium- and long-term reduction objectives and doubt about the sustainability of the system beyond phase 3 (post-2020);

Players observe that there is a lack of clarity in emission reduction objectives post-2020: If the 1st commitment of the climate package results in a reduction objective of -21% in CO₂ emissions in sectors under ETS in 2020 in comparison with 2005, there is no clear objective beyond that date. The EU ETS directive stipulates that the number of market allowances will continue to decline by 1.74% per year beyond 2020, this being equivalent to an objective for the EUETS sector of -38% in 2030 when compared to 2005, but this is not clearly structured or displayed.

More recently, the Commission provided *guidance* in December, 2011 in its 'roadmap for moving to a competitive low-carbon economy in 2050' on emissions reduction for the EUETS sector of between -43 and -48% in 2030 in comparison with 2005.

Finally, the political uncertainties of EU Member States to commit to ambitious climate objectives (notably as part of international climate negotiations) also disturb players' visibility on the sustainability of the mechanism.

A lack of consistency and coordination between the objectives and the linkage of various public policies regarding energy and climate change

Although today, the fight against climate change is considered in all EU texts, this is not necessarily reflected adequately in the Climate Energy Package adopted in 2008, which has several interdependent objectives: reducing greenhouse gases by 20% by 2020 in comparison to 1990; increasing energy efficiency by 20%; reaching a 20% proportion of renewable energy out of the total EU energy consumption by 2020.

The support policies put in place in the Member States to reach the renewable energy and energy efficiency objectives result in a reduction in CO₂ emissions and thus, the demand for allowances. This pushes the price of CO₂ down and weakens market credibility as a signal to low-carbon investment. Hence, for UFE, the 'carbon signal price' should actually reflect the priority that we wish to give to climate change by indicating a CO₂ price which justifies investment in low-carbon assets.

The strictness of operational rules of the ETS system

Structurally, the ETS market is based on a pre-determined allowance supply and remains fixed throughout the period (for phase 3, until 2020). That being said, the demand varies more quickly and depends on several factors (CO₂ emissions reduction objectives assigned by regulation, other public policies representing interactions with CO₂ emissions reduction, macro-economic environments – for example, the economic crisis).

In such conditions, there is a significant risk that some States may seek to correct the system by pursuing individual and unilateral initiatives, or even that the system itself may be called into question, which is clearly undesirable.

UFE therefore believes it necessary to rapidly find solutions aimed at strengthening the system.

Various options are currently being discussed in different forums.

Before taking up a firm position on one or a combination of any of these propositions, it is essential for UFE to evaluate both their market and carbon price signal impacts, as well as taking a more global look at their impacts on the objectives which have been assigned to the system. It is equally necessary to evaluate the potential impact on European electricity prices and the various effects studied on both the wholesale market and the end consumer.

UFE also stresses the need for consistency and coordination of policies surrounding climate change and energy (Energy Efficiency, Renewable Energies...); in particular, the need to quantify expected CO₂ emissions volumes savings which may result from the implementation of these policies.

Furthermore, having a **harmonized Europe-wide system** is an essential part of market liquidity and its proper operation.

Finally, whichever intervention options are decided upon, **it is imperative that they be predictable.** Any arbitrary intervention would undermine confidence in the mechanism, with the suspicion that it might be called into question by the public authorities at any moment.

UFE'S RECOMMENDATIONS

UFE believes that any measures that may be taken must be part of the target vision of the framework and operation of the ETS system for the long-term. Indeed, the relationship between short-term/long term objectives and compliance methods is essential for the successful operation of the ETS market. As a result, solutions to be implemented could include a mix of complementary and consistent measures which would be established at different points in time depending on their ease/speed of validation and deployment.

1. Medium-term measure, requiring rapid initiation: Fixing a binding target reduction objective to phase 4 of the ETS mechanism

It is essential for energy players to have a signal price consistent with the duration of their investment cycles (long-term).

Better visibility of 'controllable' CO₂ price formation components is an economic necessity for a policy which seeks to induce a trajectory of technological change and, more particularly, of electricity generation mixes which are compatible with medium- and long-term emissions reduction objectives. The lack of any anticipatory signal runs the risk of causing a far more expensive and more significant reduction after 2020.

A post-2020 visible affordability ratio

Article 9 of the ETS directive (2009/29) states that: 'The Community-wide quantity of allowances issued each year starting in 2013 shall decrease in a linear manner beginning from the mid-point of the period from 2008 to 2012. The quantity shall decrease by a linear factor of 1.74 % compared to the average annual total quantity of allowances issued by Member States in accordance with the Commission Decisions on their national allocation plans for the period from 2008 to 2012'. It goes on to state that, 'The Commission shall review the linear factor and submit a proposal, where appropriate, to the European Parliament and to the Council as from 2020, with a view to the adoption of a decision by 2025.'

So, while this rate of -1.74% of annual reduction in allowance volume appears in the Directive – and will apply after 2020 – the objective of -38% that it represents for 2030 in comparison to 2005 is neither asserted nor implied.

Similarly, the 'Roadmap 2050' published by the EU Commission in December 2011, defined long-term trajectories and guidance for greenhouse gas emissions: in particular, the 2030 crossing point for ETS sectors would correspond to a reduction of between -43% and -48% in 2030 when compared with 2005, an objective which would therefore be more restrictive than the implicit objectives provided for in the ETS directive.

Formulating a mandatory objective for phase 4, as well as a clear trajectory for reaching it and clear reduction guidance for 2040 and 2050, will encourage the emergence of a signal price which will enable long-term investments in low-carbon technologies.

UFE supports a binding target reduction objective to phase 4. This objective must be set as soon as possible and it must be in line with other long term objectives to 2050. To avoid overly consequential market developments, it will be necessary to ensure smooth objective growth over intermediate points.

Such a measure would provide the necessary visibility to allow long term investments and to limit “shocks” due to players’ expectations.

2. One-off adjustment of allowances volumes

In addition to the fixing of a more ambitious post-2020 target reduction objective to compensate the oversupply of allowances, UFE supports the idea of creating a specific mechanism allowing one-off and temporary adjustment of allowance volumes. The French electricity industry invites the Commission to launch an impact study as soon as possible in order to analyze the consequences of implementing such a mechanism in the short term.

To do so, UFE would like to highlight that such a tool should be in line with the philosophy of the ETS scheme (a quantitative instrument). It should aim to influence the overall supply of allowances available on the market (and not the allowance price) in order to deal properly with the asymmetry between supply and demand. Any implementation should be subject to a coordinated decision at the European level and to harmonized procedures and objectives.

Among the measures likely to accentuate the scarcity of short-term allowances (review of the 2020 objective, ‘set aside’, etc.), more attention should be given to the removal of allowances on volumes auctioned in phase 3.

On February 28th 2012, the ITRE Committee of the European Parliament adopted its position on the proposal for a Directive on Energy efficiency (EED). In the Article 19, the MEPs introduced a provision that calls the European Commission to propose an impact assessment of the Energy efficiency Directive on the ETS mechanism and if needed, to amend the ‘Auctioning’ regulation in order to *‘implement appropriate measures which may include withholding of the necessary amount of allowances’*.

UFE considers that this measure could be implemented quickly through the Energy efficiency directive and would recreate an appropriate scarcity in the carbon market (-1.1 billion allowances).

However, a further clarification of this ‘set aside’ mechanism is needed as there can be several possible options to implement it:

- Limitation of auctioned volumes at the beginning of the period and re-injection at the end of this period.

Studies on the impact of the 'set aside' method on the allowance price have shown significant effects on the ability to keep the CO₂ prices at an adequate and constant level. Indeed, it appears that a withdrawal of allowances which would then be re-injected at the end of the 3rd period would have an immediate impact on the price, but it also shows that a re-injection in the market in 2017 would lead to zero valuation of the allowance in 2018-2020.

- Limitation of auctioned volumes at the beginning of the period and re-injection of those allowances into the following period in line with the objective of the phase 4.

According to preliminary analysis, a smooth withdrawal of allowances during phase 3 and a re-injection into the following period could help restore price levels and create long-term incentive which is a key issue of the ETS scheme for the electricity industry.

However, the volume of allowances that should be reintegrated after 2020 should be fixed in advance in accordance with the mandatory objective for 2030 in order to give overall consistency to the adoption of various measures.

- Limiting of auctioned volumes and immediate cancellation of withdrawn allowances.

Although this measure might seem to be efficient, UFE underlines that such an option is not compatible with a long-term UE CO₂ targets and therefore that it would not deliver sufficient visibility to the economic operators.

UFE considers that, if the proposal of the ITRE Committee which calls for one-off adjustments of allowance volumes were to be adopted, such a proposal should be subject to an impact study in order to define the operational methods that should be used to implement this "adjustment" and to evaluate its consequences in regard the objectives of the ETS market.

Moreover, UFE underlines that an intervention on the market should be made consistent with a long-term European CO₂ target. As a result, it must be considered only as a complementary emergency solution in order to ensure sustainability of the ETS system.

To overcome the inherent limitations of the ETS mechanism, UFE strongly believes that a global reflection on the structural methods to be used to adjust allowance quantities should be launched urgently (see below).

3. A political measure to cope with long-term approach: the creation of an independent European supervisory entity

UFE calls for the creation of an independent supervisory entity at the European level (i.e. 'central carbon bank') which would contribute to re-establish confidence in the ETS system by ensuring successful European coordination of public policies in the field of Climate change and by promoting transparency and monitoring the carbon market.

Competence for fixing quantitative CO₂ emissions reduction objectives would remain within the scope of States and governments.

By adjusting the volume of allowances, this independent entity should therefore ensure that the market delivers a carbon price which reflects short-term market developments and give to the

economic operators the right signal for long-term investments. Furthermore, it should be tasked with ensuring the centralization of information (transactions, price, real-time emissions, etc.) and to ensure their market transparency by disseminating that information to participants.

UFE is fully aware that implementing a European supervisory entity would require firm political decisions as well as long and complex negotiations. That is why this proposition must only be considered for the medium-term.

However, in order to give the system much-needed credibility, UFE proposes to immediately work on a possible evolution of the current ETS market regulation and of the surveillance mechanisms. This reflection should also consider the institutionalization of a supply adjustment mechanism.