THE PRINCE OF WALES'S CORPORATE LEADERS GROUP

The Prince of Wales's Corporate Leaders Group EU ETS Strategy

The EU Emissions Trading System is envisaged as the cornerstone of European Policy on climate change. It covers 45% of EU CO2 emissions, including power and heavy industry. However the scheme has raised serious concerns regarding the oversupply of allowances, the low carbon price and whether it is consequently proving effective. This year the EU ETS is being reviewed with a view to setting clear arrangements for the next phase (Phase IV).

This paper focuses on specific and pressing areas for reform of the EU ETS, including ambition, targeted assistance for carbon leakage, the regularity of review and phase length, and where improvements that can be made to strengthen the system in the future.

Business needs a stronger and more consistent economic signal on targets and timelines, combined with a carbon price that can effectively underpin their decarbonisation efforts and provide finance to support the development of new technologies. Therefore the primary purpose of the review should be to ensure that the price is increased in line with stronger targets and opportunities for undermining the price – by adding additional credits into the system – are removed.

Key CLG Asks

- Increased ambition in light of the Paris Agreement, secured through increasing the Linear Reduction Factor and retaining any unused Phase III allowances in the Market Stability Reserve (MSR) rather than using them for Phase IV New Entrants;
- Allocations for carbon leakage sectors should take into account increasing carbon policies faced by major competitors internationally;
- Adopt a 5 year phase length - in line with Paris Agreement and reflecting experience of EU ETS to date;
- Introduce better traceability of allowances - on the grounds of data security and fraud prevention, as well as providing better information on allocation for the future.

The **annual reduction** (Linear Reduction Factor, LRF) in the cap that the Commission has proposed is 2.2%. Their own impact assessment advised that in order to be consistent with a 2 degree warming target this annual reduction should be 2.4%. The Paris COP has set out a target of going lower than 2 degrees and aiming for a total warming of 1.5 degrees centigrade.

Proposal: The Commission should reassess the Linear Reduction Factor to align it with the ambition in the Paris Agreement.

Maintain ambition by keeping allowances under the overall cap. The current Commission proposal is for the Phase IV New Entrant Reserve to be supplied with unused allowances from Phase III.

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Proposal: To maintain ambition all allowances distributed to business under Phase IV should come from within the Phase IV cap.

Targeted assistance for companies facing carbon leakage – benchmarks and free allocation

The EU ETS has required companies to submit their verified emissions data on an annual basis and surrender equivalent CO2 allowances. This process provides an ever improving data resource that could target free allocations to compensate for competitiveness impacts more specifically in the future. In the past free allocation has provided an unearned windfall for some companies. [1]

Eligibility for free allocation is calculated based on a sectoral benchmark. The Commission proposes that, rather than reassess the benchmarks for Phase IV, they should all be ratcheted down by the equivalent of 1% each year and if it can be demonstrated that the true values significantly diverge from this ratcheted figure they can be adjusted by 0.5% in either direction.

There is concern over the blunt calculation of free allocation. It was envisaged at the start of Phase III that free allocation for non trade exposed sectors should be phased out after 2020. Following the Council Conclusions of October 2014 it has been proposed to maintain free allocation at a two tier level as noted above. In order to maintain an incentive to decarbonise, allocations could be tiered to reflect real exposure to global competition, including recognising carbon constraints in other jurisdictions. More countries and regions have taken on a carbon price in the last few years and, post Paris, it is likely that more will follow.

Proposal: In order to avoid windfall allocations and the ever present risk of oversupply **eligibility for free allocation should take into account whether major competitors face a comparable carbon constraint.** If the main competitor installations are also facing a carbon constraint it should be taken into account in deciding the compensating level of free allocation to that sector.

Phase Length:

Experience in Europe has indicated that external factors and unexpected consequences can impact a system negatively, requiring corrections to be introduced if a policy is not planned with sufficient flexibility up front. In the EU ETS for example, backloading and the introduction of the Market Stability Reserve were unplanned interventions to correct oversupply in a market that was set for an 8 year Phase. Phase IV of the ETS is scheduled to be 10 years long. Such a long period is likely to require mid phase corrections and adjustments.

Business needs stability in terms of direction of travel and sometimes faster timetables and deeper targets encourage investment rather than longer phase lengths that either allow problems to become more entrenched or require unplanned interventions to correct deviations from the policy objective.

The Paris Agreement recognised the need to revisit commitments every five years to reflect the new technologies and opportunities that arise and to ensure policies are on track. Regular reviews can make it easier to match the trajectory for decarbonisation indicated by climate science in a cost effective manner.

[1] https://sandbag.org.uk/carbonpricing/data/msr/facts

Proposal: In light of both the Paris Agreement and experience of the EU ETS, a five year phase would provide a planned opportunity to ensure that the policy continues to deliver on its objective and to revise targets and rules as necessary.

Communications from the CLG benefit from the input of the entire group but do not necessarily require the formal agreement of all member companies.

The University of Cambridge Institute for Sustainability Leadership (CISL) is not a member of the CLG but provides the secretariat to it. Decisions of the CLG do not represent the policies or positions of CISL or of the wider University of Cambridge

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Background and Analysis

Taking a step back we should remind ourselves:

- Why the ETS is the preferred policy to deliver emissions reductions in Europe?
- What can be learned from the last 10 years?
- What does business need to incentivise action in the future?

I. <u>Why the ETS is still important?</u>

Emissions trading allows businesses flexibility to develop their own decarbonisation strategies within a timeframe and using means that are cost effective for them.

Where there is potential competitive disadvantage created by facing a carbon price that isn't experienced in other countries free allocation of emissions permits can reduce or remove that disadvantage whilst still reducing carbon overall.

The single carbon price in Europe provides a level playing field which is responsive to outside factors – for example, during the economic collapse of 2008 the price fell quickly allowing businesses to comply at lower costs.

Trading emissions will quickly uncover low and negative cost emissions – and it is likely that the EU ETS has been successful in this respect. However, to maintain its impact to higher cost emissions reductions and to more complex reduction strategies there needs to be a stronger and clearer expectation that carbon allowances will become more scarce.

If carbon allowances are auctioned they can provide an income stream for governments to invest in RDD in new technologies and practices that will assist the energy transition.

II. What has been learned

The first ten years of the EU ETS are characterised by a surplus of allowances. The causes of the surplus are three fold.

1. The deep and prolonged economic down turn in Europe, starting in 2008, which reduced industrial production and the consequent demand for carbon allowances
2. The success of carbon pricing in encouraging changes to operations, production and investment in some sectors to reduce their carbon emissions, depressing demand for carbon allowances and therefore their price
3. The supply of cheap and plentiful credits from projects outside the EU - which were additional to the European allowances, but were allowed to be surrendered by EU ETS participants for compliance. Although a limit was put on the percentage of credits that could be used, as these credits were additional to the total cap on emissions in the ETS they reduced demand, and hence the price of EU allowances.

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There were also, during the course of the first decade, data and fraud issues that were dealt with as they arose. During that time the development of a single European registry has meant that there is a better capacity for dealing with the security of transactions in a consistent manner across Member States.

For some leading companies reducing emissions has become synonymous with efficiency and they have found ways to successfully reduce emissions at negative or very low cost. This may have required other changes to occur within those companies – for example, changing pay back period rules - but the carbon price has supported these changes. This is a success of the ETS but its impact has been to contribute to the oversupply of allowances.

For power generation, where the price can be passed on to consumers, it is inarguable that the renewables target has been much more important than the carbon price – though again the carbon price has provided support for action.

For some sectors, emissions reductions are more challenging and expensive. These sectors are characterised not just by their energy intensity but also by their inability to pass on costs (as they operate in globally traded sectors) and their vulnerability to international competition.

III. What is needed for an effective EU ETS in the future

The ground has shifted over the last 10 years and, in the light of the Paris Agreement, will continue to move. Other economies have taken on carbon policies and, post Paris, there is ever stronger interest in carbon pricing as jurisdictions seek to deliver their Nationally Determined Contributions.

Focus on the prize – maximising political capital

The limits of the review of the EU ETS were set out in the Council Conclusions of October 2014. Of particular note being paragraphs 2.1 – 2.9, which call for free allocation to be maintained to protect sectors at risk of losing international competitiveness "*as long as no comparable efforts are undertaken in other major economies*", for benchmarks to be regularly reviewed and the direct and indirect costs of carbon pricing to be taken into account and compensated in line with State Aid rules. The need to fund innovation, new entrants and modernisation of poorer EU states is acknowledged and the share of free allocation should be maintained. However, the Council Conclusions also make clear that the Environment Council will keep all elements of the framework under review and in particular will revisit the targets "after the Paris Conference".

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