

IETA position paper on EU ETS market functioning

IETA considers that the EU ETS has had a successful first 21 months of operation although significant improvements can be made. This paper will first identify how success may be defined and how it has been achieved in practice and will go on to identify areas in which improvements can be made for the remainder of phase I and going into phase II.

a) Metrics of success

The basic precepts against which IETA judges the success of the ETS as agreed in the March 2006 paper on “The Emissions Trading Scheme” are:

- Environmental delivery
- Adherence to the Lisbon agenda for competitiveness
- Promoting technological and innovation deployment particularly in developing countries
- Change in corporate culture
- Effective market functioning

Section b) of this paper will discuss to what degree these precepts have been achieved to date.

The IETA position paper on EU Emissions Trading Implementation, Linking and Review, July 2005, and subsequent ad hoc discussions highlight the following practical additional criteria needed to achieve the above success metrics:

1. Phase II NAPS to demonstrate how each member state will reach its Kyoto Target.
2. Phase II National Allocation Plans to be presented in a more timely and consistent manner, to include consistent definition of an installation, consistent treatment of new entrants, closures and transfers and allow de minimise threshold for small installations. Encouragement to allow full and free use of approved Kyoto Units for compliance
3. Linking of the Community Transaction Log with the ITL and implementation of Article 17
4. Well organised release or cancellation of Phase I reserves
5. Finalised Romanian and Bulgarian NAPs for phase I
6. Central and coordinated release of all commercially sensitive information
7. Transposition of Linking Directive by all member states
8. Clarification of tax and accounting treatments
9. Competitiveness impacts of the EU ETS

MARKET SOLUTIONS FOR GLOBAL ENVIRONMENTAL PROBLEMS



Section c) of this paper will examine these practical criteria and identify areas of improvement that may be applied for Phase II.

b) Tracking the success of the EU ETS

Environmental Delivery is the ultimate objective of the EU ETS and its ability to achieve this has been questioned on the basis of the April 2006 verification reports, which showed the total allocated allowances in many member states to be greater than the verified emissions. When projections are used to set targets it is inevitable that these projections will differ from the actual emissions. The fact that the difference in Phase I was downward may reflect the prudence of regulators given the projection uncertainties. In Phase II, uniform, verified data can be used as the basis of projections and the risk of significant deviations from projection will be reduced hence giving regulators and the Commission more confidence when setting targets to bring member states in line with their Kyoto commitments. As a counterpoint to the above, it has been proposed that some of the excess in allowances in 2006 may have been caused by real emission reductions were. By some optimistic calculations, up to 100 million tonnes CO₂ were reduced due to the increased effective cost of power generation from coal, which led to the use of more gas for power generation during certain periods of 2005.

The **Lisbon agenda for competitiveness**. A result of the EU ETS has been the negative impact on companies exposed to global competition as well as on the potential security of energy supply. However, the elimination of this negative impact can and should be accomplished through measures (such as allowing unrestricted use of CERs and ERUs) other than changes to the EU ETS that could detract from the efficient functioning of the market and introduce new uncertainties.

It is clear that the EU ETS has been the driving force behind the current extraordinary growth in the CDM market, which is **promoting technological and innovation deployment in developing countries**. The project-based carbon market represented transactions of some 193 million tonnes CO₂e in the first half of 2006 and 374 million tonnes CO₂e in 2005. The CDM, driven by the ETS is also speeding up technology transfer. Issues such as waste management in cities in the developing world, totally ignored in the past, are now being addressed. The EU ETS through its linkages with CDM and JI has the potential to allow the EU to take the lead in climate change while at the same time, through the use of cost effective credits from CDM and JI, keeps EU industry globally competitive. To fulfil this potential it is imperative that the ITL, which allows CDM and JI credits to enter the EU ETS become operational as soon as possible and that there should be no limitations on the use of CERs and ERUs by installations covered under the EU ETS.

The ETS has led to a **change in corporate culture**. The price of emitting CO₂ is being factored into the everyday operations of around 13,000 installations across Europe, and provides monetary rewards for those companies innovating to reduce emissions. The extensive work of monitoring, reporting and verifying each installation throughout



Europe was carried out with little fanfare yet the results were mostly submitted in time for the March 2006 reconciliation – a truly impressive achievement.

Effective market functioning has been achieved. Even during highly volatile trading periods. Bids and offers have been consistently available across many trading platforms and market participants have mostly been able to get in and out of modest trading positions quickly and easily. The participation of large financial institutions such as banks and hedge funds in the carbon markets is critical for contributing to maintaining a liquid well functioning market and contributes to the increasing credibility of the market. Trading has been dynamic, with at least 780 million European allowances traded to date and the market has largely reacted in a logical manner to changes in underlying supply / demand fundamentals. Inconsistencies in these reactions are likely to reduce with increasing maturity. The linking of the National Registries with the CTL was carried out in a timely manner for the majority of Member States and the robustness of the registry system was successfully tested on December 1st 2005 when the majority of transactions from the previous year were settled.

c) Areas of improvement going forward

The Phase II NAPs should facilitate a material contribution to the legally binding targets under the first Commitment Period of the Kyoto Protocol and **demonstrate how each member state will reach its Kyoto Target** in the context of their wider climate change policies. This should include addressing sectors that are not covered by the EU ETS with the same level of ambition in terms of emission reductions as those in the trading scheme. It should also ensure that countries on track to meet their Kyoto Targets do not allocate more than their installations are realistically likely to need. Any perceived lack of environmental delivery will cause a serious crisis of market confidence in the EU ETS approach.

In April 2006 the market was made noteworthy by two phenomena: a rapid price drop and high volatility. The drop in price demonstrated the market reaction when the regulator is not perceived to have been strict about the environmental objective and emission reductions. At this juncture the perception of an excess of allowances in Phase I caused a rapid collapse in market confidence in the integrity of the scheme (which inherently requires an initial short position of allocated allowances versus expected emissions in order to meet its environmental objectives) and hence market prices. Policy makers need to give the market the confidence not only that these targets are sufficient but also that the targets will be met and enforced.

The volatility in the market price was largely caused by the irregular release of incomplete information into the market, which also needs to be improved in subsequent sessions (see below).



Another lesson of Phase I is that **National Allocation Plans need to be submitted in a timely manner** to sustain the credibility of the system and for participants to have sufficient time to prepare their emission reduction and trading strategies. As of mid-September 2006 only 9 out of 25 Member States have officially outlined their plans for phase II. **NAPs should be presented more consistently** than in Phase I and include overall national emissions targets and offsets from Kyoto credits, current business as usual projections, assumptions for reductions in ETS and non-ETS sectors and detail new entrant reserves, auctioning and banking provisions. In addition, Commission decisions regarding the NAPs should be published showing clear reference to the relevant rules used to make these decisions.

Effort should be made to improve the consistency amongst Member States regarding their **definitions for an installation** since the current differences cause installation exceptions where there should be none. Furthermore, the **treatment of new entrants, closures and transfers** requires significant scrutiny in the new NAPs as each of these procedures can cause embedded optionality for the Member State regarding the number of allowances they actually release into the market which subsequently causes supply uncertainties and a lack of confidence in the market. A strong review, in particular, of the anticipated treatment of unused new entrant reserve pools should be completed. A **de minimise threshold for small installations** should be encouraged as this measure, as implemented in The Netherlands in Phase I, significantly reduces the administrative burden of the scheme without significantly harming environmental delivery. Finally, Member States should be encouraged to allow the **full and free use of approved Kyoto Units for compliance**. This allows real emission reductions to occur while keeping European industry operating competitively. The use of these units should be supported by EU governments to provide developing countries and countries in transition with the technology for the abatement of GHG emissions.

The **linking of the CTL with the ITL** needs to happen no later than April 2007 in order to start the process of the trading of secondary CERS and ERUs in the market as well as assuring the continued ease of transfer of EUAs entering into the Kyoto period. Member States also need to implement **Article 17** in order for trading to continue smoothly and the Commission will need to enforce this activity as 2008 approaches.

For the remainder of Phase I, Member State governments should be encouraged to **release or cancel Phase I reserves** in an organised and well publicised manner. There is now little need for them with the end of the first period in sight.

Furthermore, the **NAPs for Bulgarian and Romanian entry in 2007 need to be finalised** so that these countries can benefit from the abatement potential and experience gaining offered before the start of Phase II.

The data and decisions held by the commission are of a commercially sensitive nature. To ensure the market is uniformly informed IETA recommends that there is a **central and coordinated release of all commercially sensitive information**. The publication of



Commission decisions, including NAP rulings, must be made available on a formal notified date, with fair and equal access, detailing the decisions made in a transparent manner and with relevant supporting documents translated into English.

In order to facilitate unrestricted trade of all approved Kyoto units the **transposition of the Linking Directive needs to be completed by all EU Member States** and be rigorously enforced by the Commission. The deadline for transposition has already been passed (13 November 2005) and a large number of countries have not yet complied. Furthermore, the Member State status with this implementation process should be more transparent and the national legislation should be easily accessible using, for instance, the Eurlax internet portal.

Very little international clarification of tax and accounting treatment has been achieved and IETA encourages the Commission to call for these changes so as to alleviate uncertainty which still causes problems for companies when developing their reduction and trading strategies.

Discussions centred on the competitiveness impacts of the EU ETS inevitably tend towards the competitive impact of rising power prices on large end users of power. Energy prices (coal, oil and gas) are key drivers of power prices. EU Allowances are now also an integral part of power pricing and the degree to which the costs for these are passed through to consumers is inhomogeneous throughout Europe. Crucial for improving the consistency of this pass through is the working of a competitive market, which will provide the right synergies with EU ETS.

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