

THE EU ETS @ 10: SLOGAN OR CORNERSTONE OF THE EU'S CLIMATE POLICY¹

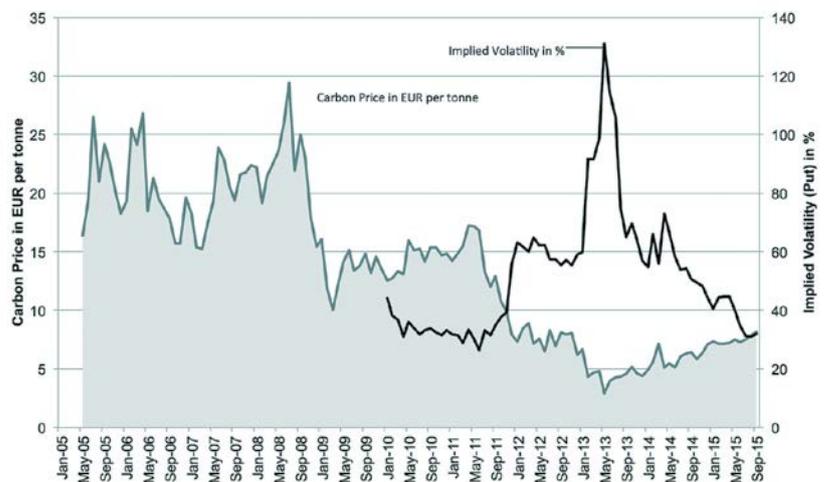
The European carbon market has been a volatile ride since the start of the EU ETS in 2005, with oversupply, recession and structural challenges to overcome. As it turns 10, Ingo Ramming reviews its first decade and debates if the EU ETS is finally fit for the future

With the start of the new millennium, carbon markets and emissions trading was the new buzz phrase which excited not only the financial community but also politicians, environmentalists and NGOs. The first trades were executed in 2003 and the start of the EU Emissions Trading System (ETS) in 2005 created a surprising feel good atmosphere and the impression that this was about more than just trading. More important, carbon pricing became a reality and moved from environmental circles into boardrooms.

Times were different. The global economy was flourishing, the Euro was strong and the EU was in expansion-mode. It was pre-financial crisis, with a strong belief in markets and deregulation. It was inspired by the challenges of transforming our energy system and preventing global warming.

However, once the economic crisis hit and the 2009 UN climate talks in Copenhagen resulted in a minimum consensus, it became increasingly difficult for policy-makers to balance often mutually conflicting goals or, as political scientist Roger Pielke Jr's phrases it in his 'iron law': "When policies focused on economic growth confront policies focused on emissions reductions, it is economic growth that will win out every time."

This is best illustrated by the development of European carbon prices. Allowance prices fell from a high of more than €30 (\$32.56) per tonne of CO₂e to €2.80 in 2013 on the back of a significant structural surplus of roughly 2 billion allowances – equivalent to one year of allocation. At the time of writing in October, prices for European carbon units were around €8.30.



WITH THE EU ETS, CARBON PRICING BECAME A REALITY AND MOVED FROM ENVIRONMENTAL CIRCLES INTO BOARDROOMS

"It's the economy, stupid", and the inflow of international offsets: these were the usual explanations for the surplus, but overlapping and conflicting policies had a significant impact, too. Furthermore, lost trust in Europe, European policies and Europe's inability to reform the EU ETS undermined the confidence of market participants. Discussions on aviation and the EU ETS were barely constructive and when negotiations on backloading, a quick fix to tackle the surplus, turned into a never-ending story, many participants switched off, frustrated that any attempt to live and learn and improve a young market were delayed.

Since then a lot has changed, and policy-makers in key European member states, the European Commission and the European Parliament stepped up and pushed for reforms. The no drama-

approval process of the Market Stability Reserve (MSR) helped to regain trust in the EU ETS and the longevity of the system. Carbon prices have recovered and implied volatilities of EUA options² fell significantly, indicating increased confidence. Still, it is too early to declare "mission accomplished" and there are significant challenges ahead to reestablish the EU ETS as the leading policy instrument for the EU's future climate change response.

The MSR will ensure a better market functioning. It will rectify the lack of supply flexibility in the EU ETS and improve price discovery. However, the MSR will only start in 2019. Auctioning volumes will increase until then and will impact the supply and demand balance.

Another important factor that will drive supply and demand are developments in

the power sector. The power sector is going through a fundamental transformation on the back of the increase in renewable energy and deteriorating power economics. Improved energy efficiency will reduce power demand. Innovation in storage and demand-side management will change the structure. Trading around actual solar and wind production will become more important to power traders than long term strategic hedging. This will have a significant impact on the behaviour of utilities, hedging strategies, the so-called “natural demand” – and ultimately the price of carbon.

This makes long term carbon price forecasts very challenging. Historically, carbon price forecasts had a bias to the upside as growth assumptions were too positive and innovation was underestimated. Therefore, policy-makers should not focus on price and create the atmosphere that a high price means a successful EU ETS and low prices symbolise failure. Rather, reforms should be made because they make sense, make the EU ETS fit for purpose and fulfill its role as the central pillar of the EU climate change policy.

The EU ETS is the instrument of choice of EU regulators and businesses to reduce GHG emissions. It guarantees that the environmental objective (the cap) is met or not exceeded. It ensures the most cost-effective abatement options are developed as the instrument does not pick and choose technologies. It is technology neutral and lets the market decide which options are developed first. Furthermore, it is a European-wide system that minimises intra-EU competitiveness distortions that national policies cause.

The discussions on the revision of the EU ETS, the 2030 Framework and the Energy Union will define the future development of the European energy and climate policy. A successful outcome will ensure the achievement of the environmental objectives without harming economic development. Furthermore, to remain the EU's central pillar for reducing GHG emissions cost-effectively, it is important to ensure efficient regulation and avoid European or national policies that overlap or conflict with the objective of the EU ETS.³

POLICY-MAKERS SHOULD NOT CREATE AN ATMOSPHERE THAT A HIGH PRICE MEANS A SUCCESSFUL EU ETS AND LOW PRICES SYMBOLISE FAILURE

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(1) Views expressed in this article are those of the author and do not necessarily reflect the opinion of Commerzbank or IETA. (2) Implied volatility is one of the most important concepts for options traders and reflects expected price fluctuations over a given period. High volatilities reflect the expectations of big changes and vice versa. (3) For more details see IETA: Overlapping Policies with the EU ETS, July 2015