

Position Paper

Principles for the efficient functioning of carbon and environmental markets - An organized markets perspective

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Environmental markets, and specifically the EU Emissions Trading Scheme (EU ETS), are the most efficient method to achieve environmental policy objectives. The main principles for the efficient functioning of environmental markets such as the ETS are predictability and credibility through stable framework conditions. These main principles must be adhered to for structural reform of the ETS and the wider 2030 climate and energy framework. EUROPEX, the Association of European Energy Exchanges, and its members actively engage in the further development of carbon and wider environmental markets as efficient means to achieve environmental policy objectives.

Introduction

There is an intense discussion taking place concerning not only the EU ETS but also the role of environmental markets in general. The “backloading” of emissions allowances as a short-term measure provoked intense debate. At the same time, the European Commission proposal for a 2030 climate and energy policy framework starts the discussion about long-term targets and the means of achieving these. The ETS as the EU’s primary climate policy instrument will play an important role in this process along with other environmental markets.

EUROPEX, the Association of European Energy Exchanges, and its members have continuously contributed to this discussion. Through its members, the association covers the complete market of environmental products, ranging from emissions allowances to guarantees of origin (GOs), but also the widest possible range of other energy-related products traded throughout Europe. Given this background, EUROPEX not only has long-standing experience in the operation of markets, but also observes the interrelations between different markets and their policies directly. From this unique perspective, EUROPEX has formulated the following key messages on the functioning of the EU ETS and wider environmental markets.

1. Environmental markets, and specifically the EU ETS, are the most efficient method to achieve environmental policy objectives

Covering more than 11,000 power stations and industrial plants in 31 countries, the EU ETS has established itself as the by far largest system for trading greenhouse gas emissions worldwide. An EU-wide cap for emissions has been established with the linear reduction factor setting out a clear and transparent path of lowering it annually. Between 2005 and 2012, verified emissions of facilities covered by the ETS have decreased by 7.3 per cent¹ with the ETS assuring cost-efficiency of emissions reductions while keeping emissions within the overall cap.

¹ European Environment Agency, 2013

A transparent and common auctioning process has been established as the default instrument of certificate allocation. In 2013, more than 40% of allowances were already auctioned and this share is set to rise progressively each year². A market in which price discovery takes place through the free interplay between supply and demand has been successfully created. In this market, the price for allowances is a result of supply and demand conditions. A lower price for allowances when economic activity decreases is not a sign of market failure. On the contrary, it shows that the market is functioning correctly and reacting to an oversupply situation.

Yet, there is a continuing discussion about the oversupply of allowances which potentially overshadows the success of the EU ETS. This stands in contrast to the global development, where carbon markets are being increasingly established. Several US states have established carbon markets, South Korea will start to operate a market by 2015 and seven existing pilot schemes in China show that also emerging economies are increasingly using market mechanisms as the way to achieve emissions reduction most efficiently. The EU ETS as the most developed carbon market worldwide and has been the forerunner in this process. This is why EU Member States should continue to build on what has been achieved today and adhere to those characteristics that have made the EU ETS successful.

The long-standing success of cap-and-trade programs has also been proven in other environmental markets. For instance, since 1995 the U.S. Acid Rain Program has proven effective to limit SO₂ and NO_x emissions under a cap-and-trade scheme.

2. The main principles for the efficient functioning of environmental markets such as the ETS are predictability and credibility through stable framework conditions

A main goal of the EU ETS and other environmental markets is to channel investment, which is often long term in nature (e.g. power plants, which are operated for several decades). The greatest deterrent to investment is insecurity, and hence investors first and foremost require predictable framework conditions for the long-term. For the ETS, this implies that it is fundamental to set the basic parameters of the system correctly. The European Council has defined the long-term goal of 80-95% emissions reductions³. To guarantee a stable framework this goal has to be translated into binding interim targets with a clear path towards achieving them.

² European Commission, 2014

³ European Council, 2009

In this framework, the existing well-functioning market mechanisms and infrastructure can steer environmental goods such as carbon emissions to their most efficient use. After all, where environmental markets such as emissions trading are chosen this is a deliberate choice because of the allocative efficiency which they provide. Environmental objectives are achieved at the lowest possible economic cost, thereby strengthening both sustainability and competitiveness.

3. The main principles of predictability and credibility must be adhered to for the structural reform of the ETS and within the wider 2030 climate and energy framework

The main principles of predictability and credibility are also crucial for any policies to further strengthen the EU ETS. This is why EUROPEX welcomes the discussion on the structural reform at the European level. In an integrated market, only policy from this level can address the functioning and efficiency of the system while preserving its environmental integrity. In contrast to national measures, only a common approach avoids the risk of market fragmentation and ensures its liquidity and efficient functioning.

Furthermore, any discussion on structural reform should build on the experience of market participants to better anticipate effects of reform on the market. Any reform should be carried out in a way that minimizes effects of political insecurity on the market, while including clear provisions for policy evaluation and review.

Environmental markets also have an important role to play in the 2030 climate and energy policy framework. The framework's central target is the reduction of greenhouse gas emissions, and the EU ETS as the main instrument of climate protection is fundamental in achieving it. It would further be strengthened by an adjustment of the linear reduction factor as proposed by the European Commission. EUROPEX supports the proposal to bring the EU ETS cap in line with the EU's 2050 long-term ambition.

EUROPEX welcomes that the 2030 framework addresses several policy areas related to the development of environmental markets. In particular, these are the finalization of the internal energy market, market integration of renewables, and the closer coordination of renewable support policies⁴.

⁴ „Guarantees of Origin: A way forward from the fallacies of current support systems for renewable electricity“, EUROPEX Position Paper, May 2014

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