



## – Feedback to Inception Impact Assessment –

### Amendment of the EU Emissions Trading System

Brussels, 26 November 2020 | Europex welcomes the Commission’s initiative to review the EU Emissions Trading System (EU ETS) to align it with the increased decarbonisation climate targets for 2030 and net zero by 2050. The emissions and energy markets will be key in delivering on Europe’s climate ambitions and scaling up innovative low-carbon technologies as well as renewable energy sources for electricity (RES). As Europe’s most successful policy to combat climate change, the EU ETS is the right tool to incentivise emissions reductions where they are most efficient and to promote investments in clean technologies, providing consistent carbon pricing across sectors. Expanding the scope to include further sectors and ensuring commitment to strong market principles is needed to ensure that the EU ETS continues driving Europe’s decarbonisation efforts in the coming decades. To this end, measures which have the effect of distorting price signals such as non-market-based or largely differing support schemes must be avoided.

Below we provide comments on the key objectives identified by the Commission for its analysis in the Inception Impact Assessment (IIA). We look forward to continuing our engagement in additional detail in our response to the formal public consultation.

#### 1. Strengthening the role of the EU ETS

**The EU ETS must remain Europe’s core instrument for reducing greenhouse gas emissions in a cost-effective way.** Since its launch in 2005, the EU ETS has successfully delivered on meeting the set targets and reducing emissions. The current market design of the EU ETS as a volumetric cap-and-trade scheme, supported by auctioning as the default method for allocating allowances and trading on transparent and liquid secondary markets, incentivises emissions reductions where they are most efficient. Simultaneously, a strong EU ETS promotes investments and innovation in low-carbon technologies and allows for tailored market-based trading and hedging strategies. In order to maintain a robust EU ETS, it is important to ensure the cap is set a level that is in line with policy ambitions and to commit to strong market principles that safeguard the undistorted price signals, efficiency, transparency and liquidity of the emissions market.

**A strong carbon market price signal based on free interplay between supply and demand is key to efficient emissions reductions.** The emissions trading price signal is the basis for the successful attainment of greenhouse gas reduction targets, with free market pricing on the primary and secondary market being decisive for this. Combining diverse sectors with a multitude of emissions reduction options ensures emissions are reduced at the lowest possible economic cost through a cross-sectoral price signal.

Europex therefore supports plans to align the emission cap with the 2030 and 2050 targets while minimising market distortion. This can be achieved by a clear long-term framework for the Linear Reduction Factor (LRF) which contributes to the system's predictability and functioning of the market in the most efficient way. For example, the recent Commission Decision committing to increase the Linear Reduction Factor (LRF) from 1.74% to 2.2% for 2021 is a first step.

In addition, the phase IV EU ETS reforms and the implementation of the Market Stability Reserve (MSR) have been effective in reinforcing the overall functioning of the EU ETS mechanism. Based on volume triggers, the MSR provides an additional policy instrument to manage market volumes and therefore plays a key role in increasing carbon prices and controlling the levels of supply of allowances. These are measures that will further strengthen carbon prices and stabilise the number of allowances in circulation, incentivising in turn the reduction of emissions. We continue to strongly discourage alternatives that may interfere with the functioning of the primary or secondary markets, such as a discretionary price management mechanism, a carbon price floor or carbon contracts for difference (CCfD), because of their incompatibility with the core ETS design as a volume-based instrument combined with free price formation.

**Increased climate ambition should be combined with increasing the auctioning share.** Auctioning is the default allocation method for allowances in the EU ETS. It is the most transparent allocation method, providing a harmonised and non-discriminatory process. The principle of auctioning and the objective of gradually moving to full auctioning are fundamental to the objective of emissions trading as it guarantees that costs of carbon are internalised. To this end, the increased climate targets should also be used as an opportunity to increase the share of allowances which is auctioned, particularly because auctioning revenues significantly contribute to climate action by funding RES projects and other innovative low-carbon technologies in Europe.

## **2. Funding the climate neutrality and decarbonisation transition**

**Market-based incentives to invest in renewable generation and innovative clean products should primarily come from a robust carbon price signal.** Additional support is already granted to immature low-carbon and carbon removal technologies through the investment grant mechanisms such as the Innovation or Modernisation funds.<sup>1</sup> In emissions and energy markets, market participants can already use the available short- and long-term trading products to efficiently manage their exposure to the carbon price signal, in parallel to other commodities. This market-based approach is the basis for the liquidity of the market, diversity and number of market participants in the system. The introduction of instruments such as carbon contracts for difference (CCfDs), designed to guarantee carbon prices and reduce project financing costs, risks a negative impact on the carbon market. CCfDs cover the difference between a variable reference price (the price of allowances in the EU ETS) and a fixed agreed strike price. Whenever the allowance price falls below the strike price, the CCfD is triggered, resulting in a payment from the contracting party (typically the government) to

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<sup>1</sup> Other forms of support and funding include the InnovFin Energy Demo Projects ([Link](#)); Connecting Europe Facility grants ([Link](#)); Horizon 2020 ([Link](#)), InvestEU Programme ([Link](#)); Modernisation Fund ([Link](#)); Just Transition Fund ([Link](#)); and Enhanced European Innovation Council (EIC) pilot ([Link](#)).

the beneficiary. However, such socialised subsidy schemes lead to short- and long-term market price distortions, reducing the effectiveness of the price signal as a short and long term operational and investment decisions driver. CCfDs ultimately risk undermining markets which are used to manage exposure to carbon price risk. Publicly backed CCfDs pose particular problems in terms of their impact on the emissions forward market, effectively reducing the need for market participants to hedge their risks on the derivatives market. Further, the cost of managing this risk is also ultimately transferred to the public, rather than managed via the competitive energy market.<sup>2</sup>

The evolving policy ambition and future carbon price developments must also be taken into account. Following the likely increase of the EU climate targets to a proposed 55-60% reduction in emissions and the commitment to carbon-neutrality by 2050, carbon prices are estimated to double over the next decade<sup>3</sup>. The upcoming Phase IV reforms aimed at reducing the volume of allowances in circulation will also further strengthen the carbon price. Strengthening the carbon price by setting an appropriate cap and LRF should be prioritized as it corresponds well to potential concerns that the EU ETS carbon price is too low to allow low carbon product technologies to be competitive against higher carbon-intensive ones

Other CCfDs drawbacks that must be considered include their limited effect to provide substantial protections to low-carbon production projects, their reliance on public funds, and asymmetry of information. First, CCfDs are usually awarded via competitive auctions, and while it can prevent leakage from the specific projects it covers, they do not offer any immediate competitiveness benefits for the sector at large. Secondly, relying on subsidies from governments when there are market solutions available should not be the way forward to fund the energy transition, particularly during times of tight budgets. Like other support policies, a CCfD relies on the availability of limited public funds to the detriment of the end consumer who will ultimately bear the increased costs. Thirdly, information asymmetries can also make it hard for governments to gauge the true cost of bidding technologies and the required carbon strike price, something that competitive bidding processes can alleviate, but not eliminate.

### **3. Extending the scope of the EU ETS to relevant sectors**

Over the past decade, the EU ETS has efficiently delivered on reducing emissions and meeting the set targets for the sectors under it applies to. However, for sectors outside the EU ETS the picture is more mixed, with overall lower reduction levels in addition to significant differences between Member States, which struggle to meet their 2020 emissions reduction obligations in non-ETS sectors.

Today, the emissions trading mechanism already provides a cross-sector price signal which can be expanded to further sectors, both in a geographic and in a sectoral respect. In a

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<sup>2</sup> The Europex response to the consultation on the EU offshore renewable strategy (24 September 2020) provides more detail on the potential negative market impacts of CfDs ([Link](#)).

<sup>3</sup> Some analysts suggest that carbon prices could increase by 50% over the next decade:

<https://www.reuters.com/article/us-climate-change-eu-carbon-idUSKBN2682ZQ>

<https://www.argusmedia.com/en/news/2142240-eu-ets-price-3265t-under-2030-scenarios>

<https://www.edie.net/news/6/Carbon-prices-set-to-climb-by-50--over-next-decade-following-raised-EU-climate-targets/>

geographic respect, the EEA-EFTA states<sup>4</sup> have been included in the system. In a sectoral respect, the EU ETS has already been expanded several times both at a national and at a European level. Examples of this are the inclusion of air transport and of the aluminium sector at a European level and the additional plants from the heating sector in several member states.

From a market perspective, the preferred option for implementing carbon pricing in additional sectors is their inclusion in European emissions trading. Wide sectoral coverage encompassing a great number of diverse market participants optimises the efficiency of emissions reductions. Including additional sectors offers the possibility to introduce a cap on carbon emissions for additional sectors for the first time. Such expansion will ensure these sectors decarbonise efficiently and will provide market actors with a strong price signal to guide their economic activity. As such, an EU ETS expansion will be key to encourage investment in cost-effective abatement technologies and drive further integration between sectors where it is most efficient. With EU ETS expansion, thus, the market as whole including all market participants directly benefit from a larger, more efficient market with increased liquidity. Further, additional sectoral coverage can support linking of trading schemes, as the system becomes more attractive for global partners to link with.

## **About**

Europex is a not-for-profit association of European energy exchanges with 29 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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<sup>4</sup> Iceland, Liechtenstein and Norway.