

EU ETS Reform - EURELECTRIC recommendations on proposals to strengthen the EU ETS

A EURELECTRIC position paper

November 2016

EURELECTRIC is the voice of the electricity industry in Europe.

We speak for more than 3,500 companies in power generation, distribution, and supply.

We Stand For:

Carbon-neutral electricity by 2050

We have committed to making Europe's electricity cleaner. To deliver, we need to make use of **all low-carbon technologies**: more renewables, but also clean coal and gas, and nuclear. Efficient electric technologies in **transport and buildings**, combined with the development of smart grids and a major push in **energy efficiency** play a key role in reducing fossil fuel consumption and making our electricity more sustainable.

Competitive electricity for our customers

We support well-functioning, distortion-free **energy and carbon markets as** the best way to produce electricity and reduce emissions cost-efficiently. Integrated EU-wide electricity and gas markets are also crucial to offer our customers the **full benefits of liberalisation**: they ensure the best use of generation resources, improve **security of supply**, allow full EU-wide competition, and increase **customer choice**.

Continent-wide electricity through a coherent European approach

Europe's energy and climate challenges can only be solved by **European – or even global – policies**, not incoherent national measures. Such policies should complement, not contradict each other: coherent and integrated approaches reduce costs. This will encourage **effective investment to** ensure a sustainable and reliable electricity supply for Europe's businesses and consumers.

EURELECTRIC. Electricity for Europe.

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This position paper on EURELECTRIC's recommendations on proposals to strengthen the EU ETS is being published in support of EURELECTRIC's [Position Paper](#), [Proposals for Amendments](#) and [Statement](#) on the Commission's legislative proposal to revise the EU Emissions Trading Scheme Directive.

KEY MESSAGES

- EURELECTRIC's members are committed to delivering a carbon neutral power supply in Europe by 2050, and to ensuring a competitively priced and reliable electricity supply throughout the integrated European energy market. EURELECTRIC supports a strong EU ETS as the cornerstone of the EU's climate and energy policy. We support the **EU ETS as a key driver for market-based investments in low-carbon electricity generation**. In our view, this is the best way to underpin the provision of affordable, reliable and sustainable electricity supply to support the EU economy.
- In light of the ambitious outcome of the Paris Agreement, EURELECTRIC has undertaken a study to analyse the possible impacts of some of the proposed options to strengthen the EU ETS. Based on the results of this study, EURELECTRIC supports the **introduction of amendments to the Commission's proposal to revise the ETS Directive** so as to obtain a meaningful price signal both in the short and longer term:
 - Achieving the EU's decarbonisation objectives in a cost-efficient way would require addressing both the long term and short term supply of allowances. While an adjustment to the Linear Reduction Factor (LRF) would align the EU ETS with the higher end of the EU's 2050 decarbonisation objective, a concurrent revision of the parameters of the Market Stability Reserve (MSR) would address the continuing short and medium term excess supply in the EU ETS. **EURELECTRIC therefore proposes to increase the LRF to at least 2.4% and to combine this with an increase in the intake rate of the MSR to 24% per year from 2019 until at least 2023 and future-proofing the MSR by lowering the applicable thresholds (e.g. to 300-600 million EUAs across Phase IV)**. This will enable the achievement of cost-effective decarbonisation of the European electricity sector in both the short and longer term.
 - These proposed measures would lead to an increase in the ETS allowance price and associated compliance costs for the electricity sector before 2030 as a result of additional operational costs associated with the purchase of ETS allowances on the market. At the same time, Member States with high carbon intensity and low GDP/capita levels would also face significantly higher investment needs than they would under the Commission's current proposal, and would thus face a higher burden as a result of the increased ambition. Solutions to mitigate these increased costs include **using the increased income from auctioning and proportionally increasing compensation arising from the current provisions of Article 10c and Article 10d of the proposed ETS Directive**.

- **The effect of RES support and increased energy efficiency targets in the ETS sectors after 2020 should also be properly assessed and any possible overlapping effects on the supply/demand balance for emission allowances should be understood and addressed.** An improved governance process, where impacts of the additional measures are clarified in a dialogue between Member States and the Commission, will be important to ensure the maintenance of a cost-effective and market-based approach to the decarbonisation of the European electricity sector.

Introduction

The European electricity sector has strongly welcomed the Paris Agreement on climate change as a major landmark in addressing this global challenge. We consider the Paris Agreement as a truly global agreement which provides the necessary signal to governments, businesses and the general public of the universal commitment to mitigate the impacts of climate change. The commitment reached by world leaders agreed to keep the increase in global average temperature well below 2°C compared to pre-industrial levels, and to pursue efforts towards 1.5°C, provides a clear confirmation by the international community of the irreversible transition to a low carbon economy which will steer the global clean energy transition.

With the implementation of the Paris Agreement it is clear that much more needs to be done to get emissions down via cost-efficient pathways to hold the global average temperature increase to well below the 2°C commitment. A clear emissions gap exists between the objectives agreed in the Paris Agreement and the current decarbonisation scenarios and commitments of the EU and other Parties to the UNFCCC. In the light of the Paris outcome, EURELECTRIC believes that the EU can cost-effectively contribute to closing the global emissions gap by taking the necessary measures in the current reform with a view to strengthening the EU ETS in line with the EU's long term decarbonisation objectives and its global commitments.

Reform options to strengthen the EU ETS

EURELECTRIC has been a continuous supporter of the EU ETS as the cornerstone instrument of the EU's energy and climate policy to deliver cost-effective greenhouse gas (GHG) emission reductions across the traded sectors in Europe. We believe that a strong EU ETS should deliver a carbon price signal that incentivises the electricity industry to invest in an efficient and sustainable manner to meet the EU's long-term decarbonisation objectives, particularly given that investments in our sector usually have long lead times. However, the current projections indicate that the EU ETS will not deliver a carbon price signal that could enable this cost-effective investment for at least another decade.

A well-functioning EU ETS system would facilitate market-based investments in low-carbon electricity generation and would avoid the need for other more costly policy interventions to finance the energy transition. Strengthening the EU ETS would result in reducing the 'wedge' between wholesale and retail electricity prices and would also benefit the final bill of electricity customers, by reducing the need for other interventions and support measures to underpin low carbon investments.

EURELECTRIC's members are committed to delivering a carbon neutral power supply in Europe by 2050, and to ensuring a competitively priced and reliable electricity supply throughout the integrated European electricity market. We believe that this commitment to decarbonise electricity generation, together with the electrification of key sectors, such as heating and transport, will make a major contribution to help Europe meet its long-term decarbonisation objectives.

The European electricity sector believes that achieving the decarbonisation objectives agreed at the global level in the most cost-efficient way is essential to guarantee the long-term sustainability of the global economy. With this in mind, and in light of the ambitious outcome of the Paris Agreement, EURELECTRIC has undertaken a study¹ to analyse the possible impacts of some of the proposed options to strengthen the EU ETS. This analysis has been carried out with a view to delivering short and long-term cost-effective emissions reductions in the EU, which are consistent with the Paris Agreement objectives of limiting global warming to well below 2°C and pursuing efforts to limit to 1.5°C, as well as with the actions of our global competitors.

The following reform options which have also been put forward by various stakeholders have been assessed in terms of their effectiveness, efficiency, impact and timing but also in terms of additional compliance costs that these measures would imply, as well as the effects on the compensation mechanisms in the Commission's proposal:

- strengthened design parameters of the Market Stability Reserve (MSR);
- an increase of the Linear Reduction Factor (LRF) beyond the proposed 2.2%;
- a combination of the two above parameters;
- an improved governance process where impacts of other European and national policy measures on the EU ETS are assessed and addressed.

Implement a combination of a stronger LRF with an increased intake of the MSR

Based on the results of this study, EURELECTRIC supports the introduction of amendments to the Commission's proposal to revise the ETS Directive so as to obtain a meaningful price signal both in the short and longer term. According to the analysis, achieving the EU's decarbonisation objectives in a cost-efficient way would require addressing both the long-term and short-term supply of allowances. While an adjustment to the LRF would align the EU ETS with the higher end of the EU's 2050 decarbonisation objective, a concurrent revision of the parameters of the MSR would address the continuing short and medium term excess supply in the ETS.

EURELECTRIC therefore recommends implementing a combination of both measures in order to best strengthen the EU ETS as the cornerstone instrument for the delivery of European climate policy and to drive market-based investment in the European electricity sector. This should be coupled with increased ambition and equivalent policies in the non-ETS sectors as targets need to increase across the economy as a whole to ensure an optimal approach.

Increasing the rate of intake into the MSR would be an effective solution in the short-term

Substantial early action and investment are needed to ensure that significant GHG emission reductions are triggered in the short term, thereby avoiding a lock-in effect of unnecessary fossil intensive investments which would require a more costly decarbonisation in the longer term. In

¹ ICIS Study on options to strengthen the EU ETS:
http://www.eurelectric.org/media/295165/icis_study_options_to_strengthen_the_eu_ets_fin-2016-oth-0104-02-e.pdf

order to achieve this, an additional volume intervention is required in the short term, and the most effective option to do this is through an adjustment to the parameters of the MSR.

Increasing the MSR's annual intake rate, would address the current oversupply of ETS allowances on the market in the current and next trading phase, and would not affect the amount of free allocation share for industry. Significant emission reductions would be triggered in 2021-2025 and would lead to less costly abatement in later years as the MSR stock increases. Additionally, as the electricity sector becomes increasingly decarbonised, its hedging requirements will be reduced and the MSR thresholds should be lowered by 2023 at the latest (e.g. to 300-600 million EUAs across Phase IV) to account for this. This could be done in the upcoming revision to future-proof the MSR.

As a general principle, any additional allowances coming to market, such as sourcing allowances for the New Entrants Reserve (NER) from the MSR will only exacerbate the problem of oversupply of ETS allowances and should be avoided.

A higher LRF to bring the EU ETS in line with the EU's long-term decarbonisation objectives

Whilst the proposed changes to the MSR would trigger a positive effect in increasing the price in the short term, this must also be complemented with scarcity in the long run in order to ensure delivery of the long term climate objectives. Adopting a more stringent target through an increase of the LRF to at least 2.4% would help to bring the system in line with the EU's long term 2050 climate ambitions. Such an increase in emissions reduction efforts by ETS installations should form part of a wider process of increasing the EU's GHG emissions reduction ambition across all sectors and gases in the context of the UNFCCC five-year review cycle agreed in the Paris Agreement in line with the actions of our global competitors. Efficient electric technologies coupled with progressively decarbonising electricity generation will be a key pathway for the non-ETS sector transition to low carbon. Therefore the price signals in the non-ETS sectors should be adjusted to ensure a balanced contribution to this increased ambition.

According to our analysis, combining an increase of the LRF to at least 2.4% with an increased intake rate of the MSR to 24% per year from 2019 until at least 2023² and future-proofing the MSR by lowering thresholds (e.g. to 300-600 million EUAs across Phase IV) would enable the achievement of cost-effective short-term and long-term decarbonisation of the electricity sector. The study also shows that a combination of an increased LRF and strengthened MSR would by itself lead to the development of a stable price corridor.³

² The foreseen MSR review should be embedded in the general review of the EU climate policy in the context of the UNFCCC review mechanism and shall pay particular attention to extending the proposed increased MSR intake rate and the thresholds to the remaining years of Phase IV post-2023.

³ Conversely, an appropriately designed EU-wide price control mechanism combined with the functioning of the MSR should have the same kind of effects as a combination of a stronger LRF with an increased intake of the MSR.

Investments in low carbon generation are increased, but situations are different across the EU

As for the additional investment costs (CAPEX) to modernise and replace the current power generation fleet in Europe, higher ETS allowance prices would contribute to incentivising investments in new low carbon generation capacity, as their profitability will be strengthened both in absolute terms and compared to conventional carbon intensive capacity. In a well-functioning market, such new investments would thus deliver competitive returns. The electricity sector is therefore fully committed to invest to make its contribution towards the transition to a low carbon economy in Europe. However, Member States are at different levels of carbon intensity and GDP/capita levels, and the electricity sector in some Member States would face significantly higher investment needs than elsewhere and would thus face a higher burden as a result of the increased ambition.

The analysis also shows that the proposed measures would lead to an increase in the absolute compliance costs for the electricity sector before 2030 as a result of operational costs associated with purchasing ETS allowances on the market. In the long-term, the overall cost of the transition is likely to be reduced by this early increase in ambition. The additional OPEX costs in the medium term that come along with the above proposed reform options would exceed the value of the compensation mechanisms granted to some of the eligible Member States according to the Commission's proposal.

Find possible solutions to compensate disproportionate costs for eligible Member States

A solution as to how these CAPEX and increased OPEX costs (see images 2 and 4 in the Annex below) could be mitigated at the EU level needs to be found, taking into account the polluter pays principle and the increased income from auctioning. Proportionally increasing compensation arising from the current provisions of Article 10c and Article 10d of the draft ETS Directive must be considered in order to address the impact of higher carbon prices resulting from EU ETS reforms on investment and compliance costs for the eligible Member States. However, these measures should not contribute to more over-supply and weakening of the EU ETS price signal. The list of Member States eligible for these compensation mechanisms should also better reflect the actual economic situation of the Member States, for example by amending the applicable reference year to a more recent year. EURELECTRIC also proposes that the auction revenues which would increase due to higher ETS allowance prices could be earmarked and provide a potential source of funding for compensating those Member States which would be exposed to increased costs compared to the Commission's proposal.

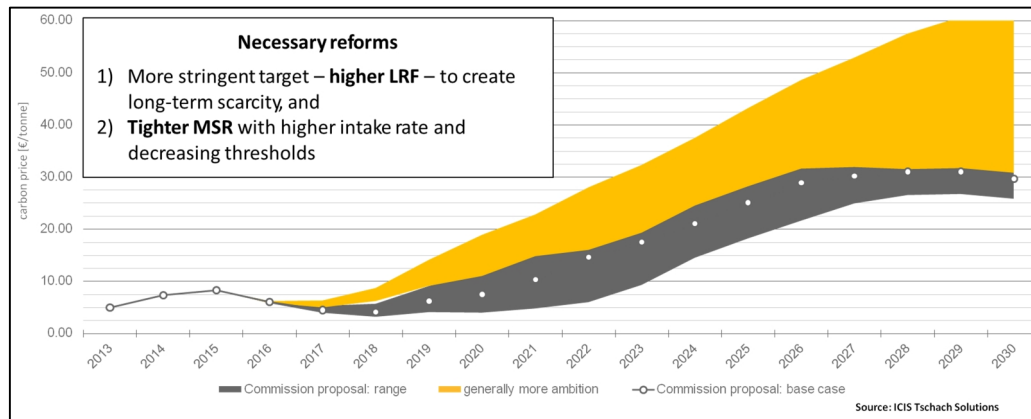
Address overlapping policies

Finally, the analysis shows that additional European and national policy measures contribute to additional emission reductions in the ETS sectors, thereby reducing demand for allowances and causing price distortions in the EU ETS. The effect of RES support, technical requirements and increased energy efficiency targets in the ETS sectors after 2020 should therefore be properly assessed and any possible overlapping effects on the supply/demand balance of emission allowances understood and addressed. An improved governance process where impacts of the additional measures are clarified in a dialogue between Member States and the Commission is important to ensure the maintenance of a cost effective and market-based approach to decarbonisation of the European power sector.

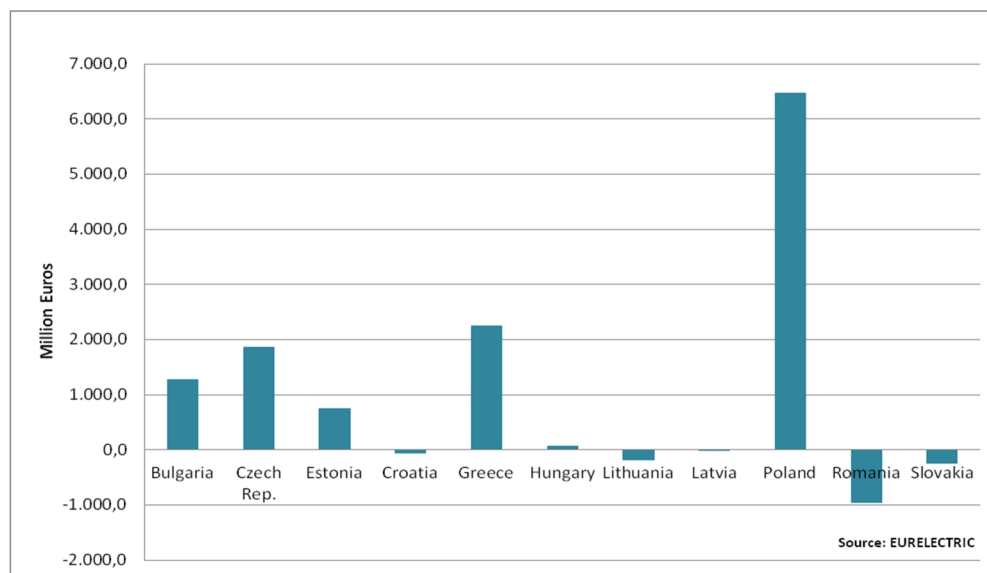
The revision of the EU ETS must enhance predictability and stability of the system, restore the confidence of market players towards the system and reduce the risk of introducing additional overlapping national measures.

ANNEX

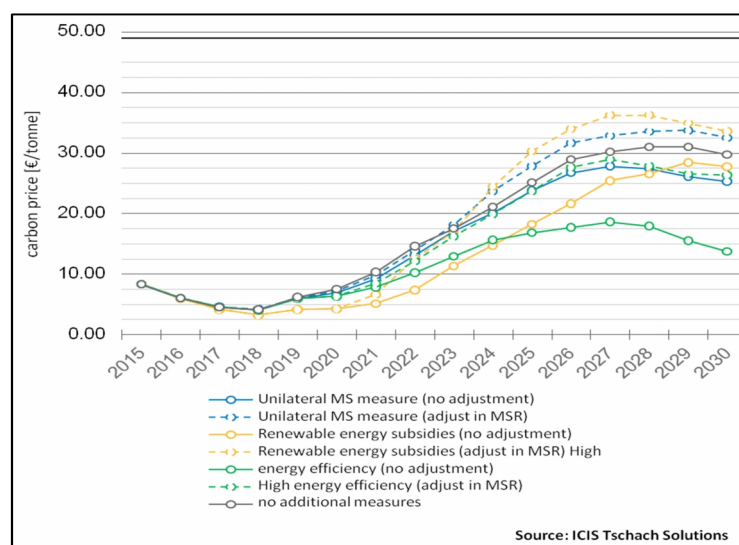
1. General impact of a higher LRF and tighter MSR on the carbon price:



2. Additional power sector compliance costs over Phase IV with LRF equal to 2.4% and MSR intake rate of 24% (over the period 2019-2030) for Member States with GDP/capita below 60% EU average:



3. Impact of overlapping policies on the carbon price:



4. Impact of the proposed EU ETS reform measures on CAPEX and electricity prices in selected Member States with high level of carbon intensity and low level of GDP/capita (national associations' estimates)⁴:

Croatia	<ul style="list-style-type: none"> According to the Croatian association (HGK) the impact on the Croatian power sector of the EU ETS reform measures proposed by EURELECTRIC amounts to approx. €1 billion of additional investment cost on top of the investment cost otherwise requested by the Commission proposal in 2021-2030 period (€1.7 billion). Additionally, this would lead to an 18% increase in electricity prices or €8/MWh higher than otherwise requested by the Commission proposal.
Estonia	<ul style="list-style-type: none"> According to the Estonian association (ETL) the impact on the Estonian power sector of the EU ETS reform measures proposed by EURELECTRIC amounts to €1.7 billion in total additional investment cost on top of the investment cost otherwise requested by the Commission proposal in 2021-2030 period. Additionally, this would lead to a 15% increase in electricity prices or €7/MWh higher, which amounts to approx. €600 million of additional electricity costs.
Greece	<ul style="list-style-type: none"> According to the Greek association (HELAS) the impact on the Greek power sector of the EU ETS reform measures proposed by EURELECTRIC amounts to approx. €6.1 billion in total additional investment cost on top of the investment cost otherwise requested by the Commission proposal in 2021-2030 period (€8.8 billion). Additionally, this would lead to a 14% increase in electricity prices or €11/MWh higher, which amounts to approx. €6 billion of additional electricity cost on top of the electricity cost projected for the baseline scenario (€48 billion in total over the 2021-2030 period).
Poland	<ul style="list-style-type: none"> According to the Polish association (PKEE) the overall capital expenditure (CAPEX) for the Polish power sector to achieve emissions reduction required by the draft EU ETS Directive (baseline scenario) is approx. €65 billion by 2030. Additionally, the EU ETS reform measures proposed by EURELECTRIC would lead to approx. 20% increase of the electricity price or €10/MWh higher than otherwise requested by the Commission proposal.
Romania	<ul style="list-style-type: none"> According to the Romanian association (IRE) the overall capital expenditure (CAPEX) for the Romanian sector to achieve emissions reduction required by the draft EU ETS Directive (baseline scenario) is approx. €15 billion by 2030. Additionally, the EU ETS reform measures proposed by EURELECTRIC would lead to approx. 12% increase of the electricity price or €6/MWh higher than otherwise requested by the Commission proposal.
The proposed measures are also expected to have a significant impact on CAPEX and electricity prices in Bulgaria as reported by the Bulgarian electricity association.	

⁴ This table is based on data and calculations received from the respective national associations. The figures are not necessarily calculated under the same assumptions and with the same model as the rest of the ICIS study. Estimates of impact on electricity prices do not necessarily take into account the reduction of the 'wedge' between wholesale and retail electricity prices.

EURELECTRIC pursues in all its activities the application of the following sustainable development values:

Economic Development

▶ Growth, added-value, efficiency

Environmental Leadership

▶ Commitment, innovation, pro-activeness

Social Responsibility

▶ Transparency, ethics, accountability



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