



Department
of Energy &
Climate Change

UK Vision for Phase IV of the EU ETS

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UK's continued support for the EU ETS

Cap and trade is the most economically efficient way to guarantee certainty over emissions reductions; alternative approaches such as taxes¹ or sector-specific targets with underpinning regulation provide less certainty on emissions reductions and are less economically efficient. Through its market-based approach, the EU ETS provides flexibility to businesses to decide whether and when to invest in carbon abatement or to purchase allowances. This flexibility enables carbon reductions to be delivered across the EU at the lowest cost. UK businesses have strongly supported the EU ETS for this reason.

The EU ETS is the world's largest² cap and trade measure and sets an example for other emissions trading systems being developed world-wide. The System has operated well from a technical perspective, with accurate recording of emissions, robust monitoring, reporting and verification and proportionate enforcement, and created a liquid market where the allowance price reflects the price needed to meet the existing cap. The EU ETS is a key pillar of the UK's strategy for meeting carbon budgets and delivering our statutory 2050 emissions reduction target.

The UK believes the EU ETS should remain the cornerstone of EU energy and climate change policy, and the centrality of the System in delivering the objectives of the 2030 framework was highlighted by the European Council in March 2014³. The UK's vision for the future of the EU ETS is for a System that:

- Delivers EU emissions reductions consistent with meeting the long-term EU objective of reducing greenhouse gas emissions by 80%-95% by 2050 at least cost, including a 2030 emissions reduction target of 40% moving to 50% in the event of an ambitious global deal, including by driving investment in the low carbon economy.
- Is designed in such a way that energy-intensive industries remain competitive during the transition to a global low-carbon economy, adequately protecting them from the risk of carbon leakage so that they can adjust over the longer term⁴.
- Demonstrates global leadership through delivery of an effective and economically efficient emissions trading scheme, ready to link with all suitable ETSs as the foundation of a global carbon market.

However, in order to achieve those aims strengthening and reform of the EU ETS is required.

¹ Cap and trade systems such as the EU ETS provide certainty over emissions and let the carbon price adjust in response to demand and supply; taxes impose a fixed price while the quantity of emissions is left to the market.

² The System currently covers over 11,000 installations across the EU. In the UK it covers around 1,000 installations and will account for 48% of GHG emission in Phase 3 (2013 to 2020). In 2013 the EU ETS represented 94% of the value and 88% of traded volume of global carbon markets

³ March European Council <http://www.european-council.europa.eu/council-meetings/conclusions/>

⁴ Carbon leakage (definition from the Commission's website) is the term often used to describe the situation that may occur if, for reasons of costs related to climate policies, businesses were to transfer production to other countries which have laxer constraints on greenhouse gas emissions. This could lead to an increase in their total emissions. The risk of carbon leakage may be higher in certain energy-intensive industries

Why does the EU ETS need a substantial reform?

A combination of factors has resulted in a lower than expected demand for allowances and therefore a weak price signal for low-carbon investment. These factors include overlapping EU policies to drive emissions reductions, the drop in industrial production during the economic downturn, an insufficiently ambitious 2020 target which is out of line with the least cost pathway to achieve 2050 emissions reductions goals, and the influx of credits from international projects.

In January 2014, as part of their proposed policy framework for climate and energy to 2030⁵, the European Commission issued a legislative proposal for a Market Stability Reserve (MSR)⁶ and signalled an intention to tighten the EU ETS cap, by increasing the Linear Reduction Factor from 2021 to facilitate a 40% domestic greenhouse gas target for the EU by 2030. The 2030 package also proposed to continue protection for sectors at genuine risk of carbon leakage beyond 2020, but with a more focused approach.

The UK has long called for reform of the EU ETS to ensure the carbon market can deliver long-term emissions reductions goals cost effectively, so the MSR legislative proposal was welcomed. However, it does not constitute the comprehensive reform of the EU ETS the UK would like to see as it does not correct the problem of oversupply in the EU ETS, and as such is insufficient to put the System on the right track once and for all. The UK continues to call for cancellation of an ambitious volume of allowances to reduce the current surplus and help restore the balance between supply and demand.

The EU ETS market currently has a surplus of around 2 billion allowances which, if not tackled, threatens to depress the signal for low-carbon investment for at least a decade⁷ and may increase the overall costs of meeting our future targets. While the surplus in itself will not prevent EU 2020 and 2030 targets from being met, the ability to use surplus allowances for compliance over the next decades reduces the need for abatement now and into the future. The result is a weak carbon price signal that is insufficient to stimulate the low-carbon investment needed now to meet long-term goals and increases the risk of carbon-intensive capital assets being built, which could make it more expensive in the long run to meet our reduction goals in a transition to tighter targets. In addition, this persistent oversupply is seen around the world as a symptom of low ambition and undermines the EU's claim to global leadership.

⁵ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52014DC0015:EN:NOT>

⁶ http://ec.europa.eu/clima/policies/ets/reform/docs/com_2014_20_en.pdf

⁷ Commission analysis http://ec.europa.eu/clima/policies/ets/reform/docs/swd_2014_17_en.pdf

shows that even with a tightened cap in Phase IV to deliver a 40% GHG target in 2030, the surplus will reduce slowly and will remain at over 2bn allowances in 2030. Any further access to project credits within the cap will prolong the surplus

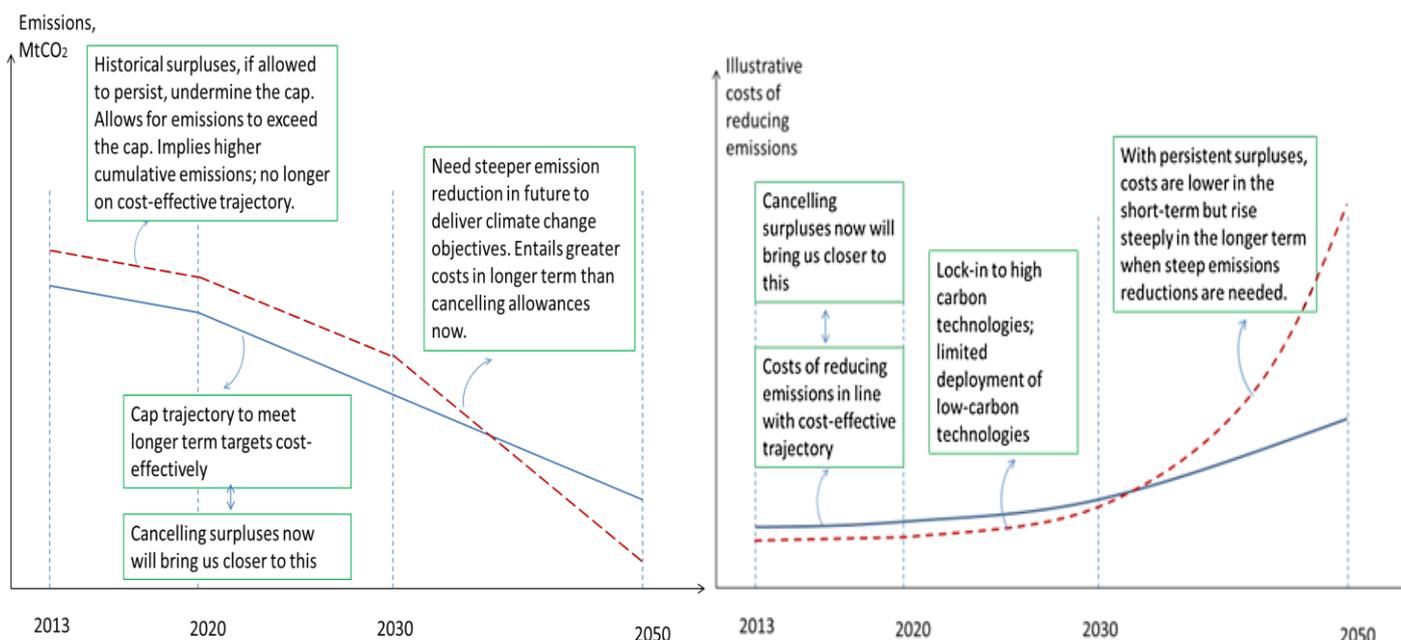


Figure 1: Stylised figure illustrating higher costs of late action pathway (Source: DECC)

In the long term the market is likely to be constrained because a significantly tighter cap will be needed to facilitate the EU’s ambition for emissions reductions to 2030 to be fully in line with the target of 80-95%, as cemented in the March 2014 European Council conclusions⁸. The EU ETS cap will need to be adjusted to deliver a 40% economy-wide 2030 domestic GHG emissions reduction target (against 1990 levels), if agreed, with the Commission proposing a 43% emissions reduction target (against 2005 levels) for the traded sector.

Addressing the risk of carbon leakage

The UK is committed to ensuring that energy intensive industries remain competitive during the transition to a low-carbon economy. We recognise the real risk of carbon leakage as a result of the EU ETS and strongly support measures to minimise it. There would be no advantage, either to the EU economy or in terms of global emissions reductions, in forcing businesses to relocate.

The UK supports the principle of free allocation as a means of mitigating the risk of carbon leakage, but it is clear that existing rules need to be improved to ensure that they are effective, evidence-based, and well-targeted. However, we are concerned that those sectors most at risk of carbon leakage may not be compensated sufficiently in the future unless current EU ETS rules are reformed, as the amount of free allocation available falls under a declining cap. In Phase IV, free allocation should therefore be focused on those sectors which evidence demonstrates are at most risk of carbon leakage.

⁸ “the specific EU target for 2030 for greenhouse gas emission reductions will be fully in line with the agreed ambitious EU objective for 2050” March 2014 European Council conclusions.

It is also clear that particular aspects of the current system must be reconsidered to remove both unnecessary complexity and perverse incentives. We therefore welcome the European Commission's proposals to continue a system of free allocation after 2020, but to focus protection on those sectors at most risk of carbon leakage and to re-visit several design features of the existing system.

Carbon leakage provisions must be based on a sound understanding of the risk faced by sectors, and informed by the range of evidence available on the issue. For instance, a number of studies⁹ suggest both that only a small number of industrial sectors are likely to be at high risk of carbon leakage, and that the risk of carbon leakage varies considerably between sectors. These findings, amongst others, must be used to inform the design of improved provisions for Phase IV of the EU ETS.

We will continue to monitor the risk of carbon leakage and consider carefully the impact of proposals for reform on the functioning of the carbon market and the competitiveness of industrial sectors. We intend to work closely with the European Commission, other EU Member States, and stakeholders over the coming period as these discussions develop.

Improving the efficiency of the EU ETS

Coverage

Cap and trade is the most efficient way to achieve a specific level of carbon emissions reductions, so the broader and deeper the carbon market becomes the more efficiently we will be able to meet our targets. The UK is open to consideration of broadening the scope of the EU ETS, which currently covers the power sector, heavy industry and aviation and includes carbon dioxide (CO₂), nitrous oxide (N₂O) and perfluorocarbons (PFCs). We continue to support the provision in the EU ETS Directive for Member States unilaterally to include additional activities and gases, which, for example, several Member States including the UK took advantage of to cover N₂O before its full inclusion in the system from 2013.

However, detailed analysis would be needed before any decisions could be taken to ensure that potential changes and cap adjustments are appropriate and risks to market stability and the carbon price are minimised. New inclusions in the carbon market would necessitate a high level of certainty over emissions and so may not be suitable for all sectors.

For the aviation EU ETS, we support the recently amended scope for an intra-European scope up to 2016. The main prize is to agree a global market-based measure to tackle aviation emissions and the UK is working closely with our international partners to deliver an ambitious deal through the International Civil Aviation Organisation (ICAO) by October 2016. An open review of Aviation ETS will follow to take account of the ICAO outcome.

Auctioning

Auctioning is the most efficient means of allocating allowances and the UK government is committed to moving towards full auctioning. The implications of any ETS reforms proposed on the orderly functioning of auctions and the carbon market will need to be carefully considered.

⁹ For example: [Vivid Economics & Ecofys \(2014\)](#); [FTI Consulting \(2014\)](#); [Oko Institute et al. \(2008\)](#); [Carbon Trust \(2010\)](#); [Climate Strategies \(2009\)](#);

The UK has a clear position against the hypothecation of auction revenues. Member States should retain fiscal sovereignty and control of decision making on the use of revenues. However, we acknowledge the clear need for increased innovation effort to reduce the cost of a range of low-carbon energy technologies so that they can be deployed as quickly and as economically as possible. This should include exploring the potential for those technologies that may increase industrial energy efficiency or reduce emissions from energy-intensive industrial processes, enabling industry to adjust over the longer term to a low-carbon economy. Funding for these types of programmes should be from existing sources, such as Horizon 2020 (the EU level research, development and demonstration funding programme replacing Framework Programme 7) and its successors, potentially alongside other sources of finance such as European Regional Development Funding, risk finance and also loan facilities through the European Investment Bank. Any potential EU Budget funding during 2014-2020 would need to be agreed as part of annual budgets that are within the 2014-2020 Multiannual Financial Framework (MFF). Additional EU Budget funding beyond 2020 – such as via the potential successor programme to Horizon 2020 – would have to be agreed as part of and within the ceilings of the next MFF (which will succeed the 2014-2020 MFF).

Reducing regulatory burdens and further simplification

The UK acknowledges that the EU ETS introduces some complexity and some administrative costs for business. While some detailed rules are needed to ensure that the system is robust and address the number and diversity of participants fairly, a balance must be struck between fairness, cost-efficiency and simplicity. Phase III already saw considerable improvements through harmonising some processes, but there is still room for further simplification. Our vision is for an EU ETS where administrative costs are kept as low as possible while preserving the effectiveness of the scheme. A leaner and administratively simpler EU ETS will achieve its objectives more effectively whilst making compliance easier and less burdensome for participants.

Greater simplification can be achieved, for example, by ensuring that small sources of emissions are treated appropriately in Phase IV. The costs and administrative burdens that small sources impose on operators can be relevant, particularly in certain sectors, and these constraints may not be justified by environmental benefits of the same level. A simplified EU ETS could help operators reduce compliance costs and administrative burdens associated with controlling minor emissions.

The UK is also in favour of further exploring the potential to opt out small emitters. The current ETS Directive provides for Member States to design and implement their own schemes to provide a less burdensome system of monitoring, reporting and verification for the operators with the lowest emissions. The EU should consider inclusion under Phase IV of a harmonised scheme that will ensure that small emitters in all Member States are able to deliver emissions reductions without incurring regulatory burdens and costs that are disproportionate to the environmental benefits.

Improving registries and MRV systems

The migration of EU Member State registry systems to a single consolidated registry operated and managed by the European Commission was a decision born from the desire to strengthen the security of the registry system, as well as to provide a harmonised centrally operated system. The focus for the registry in Phase IV should be to continue to develop security and anti-fraud systems whilst enhancing its usability and integration with market trading infrastructure and emissions reporting systems. The registry should aim to deliver on benchmark standards set in comparable systems such as those in banking and stock markets.

Greater harmonisation can be achieved through the adoption of fully automated IT system(s) supporting electronic reporting of emissions and verification activities throughout Europe. Although the adoption of standard templates is an improvement, a fully automated IT system with a common language would provide a solution to the process of integrating monitoring and reporting with the Union Registry.

Conclusion

This document sets out the UK vision for the EU ETS in Phase IV. Following substantial stakeholder engagement and consultation¹⁰ over the last two years in the UK and in Europe and internal thinking within Government, it outlines the priorities for the evolution of the EU ETS beyond 2020. The UK is keen to continue this consultation process by stimulating and facilitating an informed debate on this mechanism, of crucial importance for the EU economy.

Complete reforms for Phase IV will involve detail about the exact balance of effort between the traded and non-traded sectors, the level of ambition for the cap including the preferred shape and slope of the trajectory at any point, timeframes for action linked to progress in international negotiations, and so on. Much of that detail is dependent on factors such as the development of reform proposals already in train. This document outlines what the UK considers to be the key priority areas for action which would keep the EU ETS as a mechanism that is fit-for-purpose to bring about a cost-effective transition to a low-carbon future for the EU.

With around six years to go until Phase IV, and judging by past experience on how much interest the EU ETS can provoke and how the debate could shape up, it is hard to paint an exact picture of what it will look like in 2021. However, the principal objective for the EU, based on the fundamental mechanics of the EU ETS, should be to address the existing surplus in combination with setting a cap trajectory from 2020 to help meet overarching emissions reduction milestones to 2030 and 2050.

¹⁰ <https://www.gov.uk/participating-in-the-eu-ets>

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