INTERNATIONAL EMISSIONS TRADING ASSOCIATION

# EU ETS: UPDATE ON RECENT DEVELOPMENTS

An intensive process is underway in Brussels on changes to the EU ETS. Given the dramatic impacts of the economic crisis on emissions markets, EU policymakers are concerned that the ETS is sending a weak investment signal – particularly in light of Europe's long-term commitment to limiting emissions commensurate with holding temperature increases to 2 degrees C.

This note reviews the main changes under consideration and assesses recent developments in the policy process. IETA's full position on ETS reforms is available on our website www.ieta.org

The EU Emissions Trading Scheme is the leading edge of a global trend for governments to use cap-and-trade policies to address climate change. This trend reaches from Australia, California and the Northeastern US states to Alberta and Quebec in Canada. It is extending to the pilot systems emerging in 16 developing countries, where IETA's Business Partnership for Market Readiness (B-PMR) is active.

The International Emissions Trading Association (IETA) is a non-profit business organisation created in June 1999 to establish a functional international framework for trading in greenhouse gas emission reductions. Our membership includes leading international companies from across the carbon trading cycle. IETA members seek to develop an emissions-trading regime that results in real and verifiable greenhouse gas emission reductions, while balancing economic efficiency with environmental integrity and social equity. IETA comprises over 140 international companies from OECD and non-OECD countries

## BACKGROUND

In July 2012, the European Commission published its proposal to amend the ETS Directive, and allow a change in the timing of the auction of allowances. This proposal, known as the '**legally-clarifying amendment**' is a change to the ETS Directive and therefore needs to be approved through co-decision, i.e. approved by the European Parliament and the European Council.

On 14 November 2012, the European Commission published its proposal to backload 900 million allowances from auctioning during Phase 3 of the EU ETS. The '**backloading proposal**' plans to withhold from auctioning 400 million allowances in 2013, 300 million in 2014 and 200 million in 2015; and to reintroduce them towards the end of Phase 3 (300 million in 2019 and 600 million in 2020). This proposal, considered to be of a more technical nature, is going through the comitology procedure. This means that the Climate Change Committee will vote on the text put forward by the European Commission, and the European Parliament and Council will only have a right of veto (rather than a right to amend it). Members of the European Parliament and Member States are entitled to veto the proposal on the grounds that the European Commission has exceeded its implementing powers.

The Commission had initially suggested that both the 'legally-clarifying amendment' and the 'backloading proposal' could be dealt with in parallel. However, in order to avoid any legal uncertainty, the Commission later announced that the Climate Change Committee would only vote on the backloading proposal (going through comitology), after the legally clarifying proposal had been adopted (through co-decision).

In addition to these two files, the European Commission published on 14 November 2012, its report on the '**State of the European Carbon Market'**, related to structural reform of the EU ETS. In December 2012 it launched a stakeholder consultation on this report, which ran until 28 February 2013. The Commission organised meetings with stakeholders after the written consultation ended. The first stakeholder meeting took place on 1 March, and the second is scheduled for 19 April.

**CHART 1:** EUA PRICES 2008 - 2012


*Source: IETA Greenhouse Gas Market 2012*

## THE EUROPEAN COMMISSION HAS PUT FORWARD SIX OPTIONS FOR STRUCTURAL REFORM IN ITS CARBON MARKET REPORT.

***A)* Increasing the EU reduction target to 30% in 2020** – this proposal suggests increasing the ambition of the EU by raising the target to 30% regardless of international progress (the current EU target is a 20% reduction by 2020 compared to 1990 levels, and a conditional move to 30% if other countries make similar commitments). This option is politically challenging and has been rejected in the past by European Member States and Members of the European Parliament.

***B)* Retiring a number of allowances in Phase 3** - this would imply a permanent cancellation of surplus allowances in view of readdressing some of the challenges faced by the current low demand and fixed supply. This proposal would still need to be adopted through co-decision, but it may be implemented faster, if the Commission were to propose a decision to amend part of the EU ETS Directive, rather than a full review of the Directive.

***C)* Early revision of the annual linear reduction factor** - this option would have long-term consequences as the linear reduction factor will continue to reduce the total cap of allowances beyond 2020. This option is closely linked to parallel discussions on setting longer-term EU-wide GHG targets.

**D) Extension of the scope of the EU ETS to other sectors** - this proposal suggests including new sectors that would be covered by the EU ETS. Such an option is likely to take time before it is implemented and is unlikely to be part of the structural measures that may be introduced by the Commission during Phase 3 of the EU ETS.

***E)* Limit access to international credits** - the rationale behind this proposal is to reduce surplus allowances and to encourage emission reductions to take place domestically, inside the EU. However this proposal fails to address the problem of the lack of demand for such credits. Moreover quantitative limits already apply to certain credits relating to particular types of projects. Without greater clarification on this proposal, limiting access to credits, which correspond to valid emission reductions, does not currently seem justifiable.

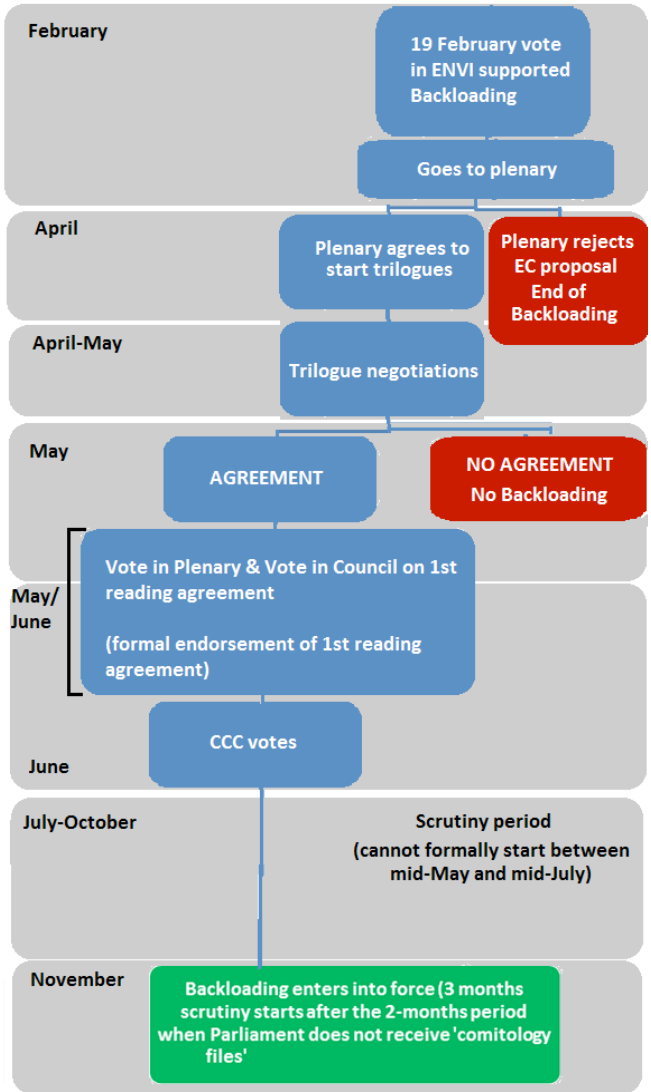
***F)* Discretionary price management mechanisms** - this measure proposes to change the design of the EU ETS, by allowing some flexibility in the supply of allowances. One of the suggestions of the European Commission is to introduce a carbon price floor in order to provide more predictability for investors. The other suggestion is an adjustable reserve, in which surplus allowances are deposited (or released from, in times of increased demand). Further consideration of establishing a flexible supply scheme is necessary, without linking this to a price management mechanism.

IETA had, in July 2012, pointed out 13 possible options for future changes to the EU ETS. IETA's contribution to the stakeholder consultation analyses the six options put forward in the report, whilst at the same time, developing those options that haven't been included in the Commission's report. IETA sees the introduction of structural measures in the EU ETS as a way to avoid future routine interventions in the market, which could cause unpredictability for market operators.

## LEGISLATIVE PROCESSES

These three files are all going through different legislative procedures. The following table highlights the key dates regarding the two files linked to backloading:

**CHART 2:** EU ETS – KEY DATES FOR BACKLOADING




The State of the European Carbon Market report is currently going through a stakeholder consultation (both a written and oral consultation with key stakeholders).

It is still unclear what the next steps will be regarding structural measures to the EU ETS. A few Member States such as the UK and Denmark, have spoken out in favour of the backloading proposal, under the condition that greater clarity be provided on what structural measures may be introduced at a later stage.

The Commission has suggested that out of the six options put forward in the Carbon Market Report, one of them could be introduced by proposing a separate decision to amend the ETS Directive, rather than a full-scale review of the EU ETS Directive. The option to retire a number of allowances in Phase 3 could therefore, in principle, be introduced at an earlier stage compared to the other options. However the likelihood of this option being introduced depends on the politics regarding how the debate around backloading evolves.

The Commission is likely to consider putting forward the proposal to retire a number of allowances only if there is sufficient support from policy makers to support the backloading proposal.

The other options are unlikely to be proposed before the new Commission is in place, so probably not before 2015.

The European Parliament has decided to start discussions on structural measures, by drafting a Resolution in the Environment Committee, and organising a debate in plenary between MEPs and the Commission. The Parliament's Resolution is expected to be adopted in July 2013, and an oral question with debate in plenary should take place at the same time. MEPs have clarified that they wish to be involved in the debate regarding structural reform of the EU ETS.

## POSSIBLE OUTCOMES FROM THE DEBATES ON THE THREE FILES

The main uncertainty concerns the legally-clarifying amendment, which will determine whether or not the backloading proposal will be put for a vote to the Climate Change Committee.

On 24 January 2013, the Industry, Energy and Research Committee voted to reject the Commission's proposal. The ITRE Committee's opinion was a non-binding opinion, and was put for a vote in the lead Committee, the Environment Committee on Tuesday 19 February. The ENVI Committee adopted, by 38 votes to 25, a report that clarifies that any change to the timing of auction of allowances would be possible once during Phase 3 of the EU ETS.

Due to a recent change in the rules of procedure, the Rapporteur from the lead Committee, Matthias Groote (S&D, Germany), needs to be given the mandate either by the Committee or after a plenary vote, to start trilogue negotiations in order to reach a first-reading agreement with Member States.

In view of the fact that the ITRE Committee voted to reject the proposal, he has been faced with increasing pressure to hold a debate in plenary before trilogue negotiations begin. A debate and vote in plenary are expected in April – after which, (depending on how the vote goes), he will be entitled to start trilogue negotiations with the Irish Presidency, representing the European Council.

Working under the assumption that the Rapporteur will be given the mandate to negotiate (after a plenary vote), by the time trilogue negotiations have concluded into a first-reading agreement, the backloading of allowances for auction is not expected to take place until the end of the year at the earliest.

The backloading proposal, which includes a proposal to withhold 400 million allowances from auctioning in 2013, may need to be revised slightly if no backloading takes places until later on in 2013. We may be in a situation where there will not be 400 million allowances left to auction if the proposal is introduced at a much later date than originally anticipated.

If the plenary votes to reject the Commission's proposal, then it is politically unlikely that any negotiations will take place between the European Parliament and Council. The Commission is unlikely to push forward its backloading proposal, if the legally clarifying amendment has failed to be adopted.

One development that has emerged in the debate surrounding the backloading proposal is the fact that two of Germany's auctions failed recently due to the auction reserve price (agreed between the auctioneer and the Member State) not being reached. Should failed auctions continue to occur, this may influence the support of policy makers for the backloading proposal.

Although the adoption of the backloading proposal will give a political signal of support for discussions on the future of the EU ETS, the debate on the long-term development of the scheme is also going to be very closely linked to the debate on a 2030 Climate and Energy Package.

A Green Paper is expected to be published at the end of March/early April of this year. A policy paper/White Paper may be published before the end of this Commission.

## WHAT HAPPENS IF….

### …the legally-clarifying amendment is rejected by the European Parliament?

The Irish Presidency, who is negotiating on behalf of all European Member States, has announced that it does not plan to negotiate with the Parliament's Rapporteur, if amendments adopted in plenary reject the Commission's proposal.

Although the Commission could, in theory, go ahead with the backloading proposal; it would be politically very difficult to do so. It is reasonable to expect that backloading won't be put forward for a vote in the Climate Change Committee if the legally-clarifying amendment is not adopted.

### …the legally-clarifying amendment is adopted by the European Parliament?

Trilogue negotiations are expected to begin. Even if a political agreement is reached on the legally-clarifying amendment, the backloading of allowances is not expected to take place until the end of the year.

It would be reasonable to expect that there wouldn't be sufficient opposition from the co-legislators to veto the backloading proposal once the legal text has been adopted.

A revised timetable for the backloading proposal is likely to be published by the Commission, in order to take into account practical considerations such as the remaining number of allowances left to auction in 2013.

### …auctioned allowances are backloaded during Phase 3 of the EU ETS?

This will buy time and ensure an informed debate on structural measures can take place between policy-makers and stakeholders.

Backloading of allowances is not expected to be a stand-alone proposal, but is seen as a first-step that will be accompanied by a discussion on the long-term development of the EU ETS.

## OTHER CHANGES AFFECTING THE EU ETS

### Amended Registry Regulation

On 23 January 2013, the Climate Change Committee endorsed the amendment to the Registry Regulation put forward by the European Commission. The text that was adopted included unclear articles, particularly regarding the proposal to limit certain types of ERU credits relating to emission reductions that took place prior to the end of 2012, from entering the EU ETS. IETA sent a list of questions to the European Commission before and after the vote in the Climate Change Committee. An updated FAQ was published on the Commission's webpage on 26 February.

The Commission clarifies its wording regarding the countries where access limit for ERUs would apply. The proposed ban on ERUs would apply for ERUs that have not yet been issued but which relate to emission reductions that took place until December 2012, unless[1]:

- The amendment to the Kyoto Protocol including a commitment for such a Party has entered into force; or
- The Party has deposited an instrument of ratification; or
- The units are issued under track 2; or
- Where Track 2 issuance is not possible, where the date of reduction (pre-2013) is certified by an accredited independent entity (AIE).

Further guidance is expected from the Commission, prior to the entry into force of the amended Regulation, on what certification process is exactly required with this change of rules.

Our understanding for the moment is that countries that have not committed to signing up to a second commitment period under the Kyoto Protocol (e.g. Russia), or have not yet deposited an instrument of ratification (e.g. Ukraine), will be affected by this change of rules.

For such countries, ERUs relating to pre-2013 emission reductions, and which still need to be issued, can only be held in ETS accounts in the Union Registry, if they are verified in accordance with Track 2 procedures, or, *if that is not possible* (which still needs to be defined) if they are verified under Track 1 procedures and certified by an accredited independent entity that the emission reductions took place prior to 2013.

The amended Registry Regulation is going through comitology procedure – Parliament and Council have three months to veto the proposal. If no objection is raised, the amended Registry Regulation will enter into force at the beginning of May this year.

## 'Stop the Clock' Proposal for inclusion of international flights in the EU ETS Directive

On 12 November 2012, the Commission decided to "stop the clock" on the inclusion of emissions from flights to and out of the EU, in the EU ETS. This temporary derogation is intended to support progress going on in ICAO. This proposal needs to be adopted by co-decision – and is expected to be adopted by the co-legislators by April 2013. This derogation would affect all international flights (including EU airlines operating international flights), but all internal EU flights will need to comply with the EU ETS.

The Environment Committee voted on the proposal on Tuesday 26 February. Compromise amendments were put forward without any strong opposition from a particular political group. There was support for clarifying that the derogation is aimed at ensuring progress is reached at the international level through ICAO. The text has also been strengthened to clarify that the derogation will not be prolonged over one year. Should policy-makers estimate that sufficient progress has been reached at the international level during ICAO's next General Assembly in September 2013, a new proposal for derogation to the rules of the EU ETS will need to be published. But the current proposal cannot be extended without a new legislative change to the EU ETS Directive that would need to be approved through co-decision.

The Committee also formally gave its support to the Rapporteur to start trilogue negotiations with Council. Parallel discussions are going on in Council, where discussions have also focused on technical considerations for Member States to grant the exemption. Once trilogue negotiations begin in March, formal approval of a first-reading agreement by the co-legislators is likely to take place before the end of April, thereby avoiding a legal loophole for operators.

The biggest point of uncertainty is how far European co-legislators will go in clarifying prior to ICAO's next General Assembly, how they feel progress should be judged, in order to determine whether or not the exemption should expire in a year's time or whether a new proposal for a derogation should be proposed.

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## CONTACT INFORMATION

For more information on IETA's work relating to the EU ETS, or if you have any queries about this briefing note, please contact Sarah Deblock

Sarah Deblock
European Policy Director
Brussels
Email: deblock@ieta.org
Phone: +32 2 230 11 60

For more information about IETA and its activities around the world, please visit www.ieta.org or email secretariat@ieta.org.



[1] http://ec.europa.eu/clima/policies/ets/linking/faq_en.htm