



# **Report on the State of the European Carbon Market**

***3 December 2012***

# State of the carbon market

- *Liquid and technically functioning well.*
- *From 2013 onwards fundamental architectural changes to harmonise the ETS.*
- *Emissions decreased by more than 10% since 2008, in part due to the economic crisis.*
- *Macro-economic circumstances give rise to the build-up of a surplus close to 1 billion allowances end 2011.*

# State of the carbon market

- *In 2012 and 2013 rapid build-up of this surplus, largely due to regulatory provisions in the transition of phase 2 to phase 3.*
- *By end 2013 surplus could be well over 1.5 billion allowances, and even as large as 2 billion allowances.*
- *Net demand in 2013 decreases because hedging demand beyond auctioning is expected to drop away.*
- *Surplus continues to grow, and will reach for most of phase 3 up to 2020 a size of around 2 billion allowances.*

# The challenge

- *The ETS Directive aims to promote reductions of GHG in a cost-effective and economically efficient manner. This aim is not limited in time.*
- *The ETS is designed to be technology neutral, cost-effective and fully compatible with the internal energy market.*
- *But the size of the surplus negatively affects investment incentives in the ETS.*
- *The ETS needs to play an increased role in the transition to a low-carbon economy by 2050.*

## Two step approach

### ***First step:***

- *Address the challenge in short term*
  - ⇒ *postponement of auctions of 900 million allowances ("backloading") – separate track*

### ***Second step:***

- *But backloading won't address structural problem, so "structural action" required*
  - ⇒ *Carbon market report starts a discussion that looks into 6 possible options for such action.*

# Options for structural measures

*Option a: Increasing 2020 target to -30%*

*Option b: Retirement of phase 3 allowances*

*Option c: Early revision of linear factor*

*Option d: Include other sectors in the ETS*

*Option e: Limit access to international credits*

*Option f: Discretionary price management*



## A: Increasing 2020 target to -30%

- *If the conditions are right*
- *Change the quantity of allowances through*
  - permanent retirement
  - or revision of the linear reduction factor
- *this requires a reduction in volume by 2020 of 1.4 billion allowances*
- *Increased ambition level would also apply to non-ETS sectors and affect the targets under the Effort-Sharing Decision*



## **B: Retirement of phase 3 allowances**

- *Retires phase 3 allowances through reducing auction volume*
- *Can be done via a self-standing Decision, thereby leaving the wider regulatory framework unchanged.*
- *Realigns ambition before 2020, but not afterwards.*
- *Direct contribution to achieving RES and energy efficiency targets.*



## C: Early revision of linear factor

- *Directive foresees this to be done as from 2020 with decision to change by 2025.*
- *This could be advanced.*
- *Would affect both pre and post 2020 ambition level.*
- *If wanted can be set in line with 2050 milestones*
- *Other important policy questions need to be addressed*
  - increase EU's low carbon technology competitiveness
  - link with international carbon market
  - risk of carbon leakage



## **D: Include other sectors in the ETS**

- *Emissions in non ETS sectors were less prone to macro-economic swings => more stable demand*
- *Also in the longer term, changes in the non ETS will impact the ETS, e.g. electrification of transport*
- *Depending on the cap set, ambition level can increase and thus surplus can be absorbed.*
- *Other important policy questions need to be addressed*
  - Who has compliance obligations?
  - How would it relate to other policies impacting these sectors?

## **E: Limit access to international credits**

- *International credits allowed to contain compliance costs, but have become major driver of the surplus.*
- *Limiting future access to credits would lower risk on major renewed surplus build up in the future*
- *Investment clarity on real domestic effort needed*
- *Flexibility could be allowed in times of demand shocks*
- *To be balanced against:*
  - Lower financial and technology flows to developing countries.
  - If international conditions are right and the cap would be strengthened, how to use as cost containment.



## F: Discretionary price management

- *Adjust auction supply so that prices are maintained at minimum level:*
  - Auction price floor
  - Reserve that sees inflow of allowances if there is a large temporary supply-demand imbalance and vice versa
- *Major change to a quantity-based mechanism.*
- *Risk on politics deciding on price level not the market, governance questions need to be addressed.*
- *If set too low, ineffective.*
- *If set too high it fixes the prices (no flexibility).*

Option	Effects supply/demand	Speed of deployment	Changes ambition post-2020	Impacts free allocation
<b>a. Increasing the EU GHG target to -30%</b>	Supply	Depends on mechanism	Depends on mechanism	Depends on mechanism
<b>b. Retiring a number of allowances</b>	Supply	Relatively fast	No	No
<b>c. Early revision linear reduction factor</b>	Supply	Slow	Yes	Yes
<b>d. Extension of the scope</b>	Demand	Slow	Depending on design	No
<b>e. Access rules to international credits</b>	Supply	Slow	No	No
<b>f. Discretionary price management</b>	Supply	Slow	No*	No
*Assuming that the mechanisms would not result in the cancellation of those allowances that are temporarily not auctioned.				

- ***Commission will shortly launch a public consultation***