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
  \[\Rightarrow\] postponement of auctions of 900 million allowances ("backloading") – separate track

**Second step:**
- But backloading won’t address structural problem, so “structural action” required
  \[\Rightarrow\] 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).
## Summary table

<table>
<thead>
<tr>
<th>Option</th>
<th>Effects supply/demand</th>
<th>Speed of deployment</th>
<th>Changes ambition post-2020</th>
<th>Impacts free allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increasing the EU GHG target to -30%</td>
<td>Supply</td>
<td>Depends on mechanism</td>
<td>Depends on mechanism</td>
<td>Depends on mechanism</td>
</tr>
<tr>
<td>b. Retiring a number of allowances</td>
<td>Supply</td>
<td>Relatively fast</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. Early revision linear reduction factor</td>
<td>Supply</td>
<td>Slow</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Extension of the scope</td>
<td>Demand</td>
<td>Slow</td>
<td>Depending on design</td>
<td>No</td>
</tr>
<tr>
<td>e. Access rules to international credits</td>
<td>Supply</td>
<td>Slow</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>f. Discretionary price management</td>
<td>Supply</td>
<td>Slow</td>
<td>No*</td>
<td>No</td>
</tr>
</tbody>
</table>

*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**