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Position Paper

Unallocated Allowances in the Emissions Trading System

Eurogas is the association representing the European gas wholesale, retail and distribution sectors. Founded in 1990, its members are 43 companies and associations from 24 countries.

Eurogas represents the sectors towards the EU institutions and, as such, participates in the Madrid Gas Regulatory Forum, the Gas Coordination Group, the Citizens Energy Forum and other stakeholder groups.

Its members work together, analysing the impact of EU political and legislative initiatives on their business and communicating their findings and suggestions to the EU stakeholders.

The association also provides statistics and forecasts on gas consumption. For this, the association can draw on national data supplied by its member companies and associations.

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Background

The European Commission (EC) has commenced its review of the Emissions Trading System (ETS) Directive in order to set out the rules on the ETS post 2020, including topics such as the linear reduction factor, modernisation fund and carbon leakage.

Separately the EC's legislative proposal for a Market Stability Reserve (MSR) is currently the subject of trialogue negotiations with the Council and European Parliament. Key issues for debate include the start date of the MSR and whether back-loaded allowances should be placed directly into the reserve. An issue which has emerged is the treatment of "unallocated allowances", arising from the trading period 2012-2020.

Unallocated Allowances – what are they?

Unallocated allowances are allowances which had been set aside for specific reasons in the current trading period, but are now unlikely to be used, which means that they would be released to the market in 2020, the last year of the current trading period[1]. There are three sources of these unallocated allowances:

(i) *New Entrants Reserve* *(ETS Directive, Article 10a, Paragraph 7)*

For sectors other than electricity production, new installations and significant extensions to existing installations are eligible for free allocation from the New Entrants' Reserve (NER) in the current trading period of the ETS. The EC estimated that, as of January 2015, 410 million of an initial reserve of 480 million allowances would remain unallocated[2]. A proportion of this reserve is expected to be used before 2020 as further new installations come online, but the majority of allowances are not forecast to be used.

(ii) *Closures or significant reduction of capacities* *(ETS Directive, Article 10a, Paragraph 19 & 20)*

Under the ETS Directive, free allowances allocated to installations that cease operations or significantly reduce their capacity are to be withdrawn or reduced respectively. Given the economic climate in Europe in recent years, this has occurred and a tranche of free allowances will not be allocated to these installations.

[1] Article 10, Paragraph 2 of COMMISSION REGULATION (EU) No 1031/2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC.

[2] http://ec.europa.eu/clima/policies/ets/cap/allocation/docs/status_table_ner_en.pdf

(iii) Transitional free allowances for electricity sector (ETS Directive, Article 10c)

A third tranche of unallocated allowances arises due to unused allowances which were set aside under Article 10c of the Directive for investment in the power sector in certain circumstances (e.g. low GDP countries with a reliance on a single fossil fuel for energy production) and have not been used.

Analysts' estimates vary on the number of unallocated allowances by 2020, but are comparable in scale. Their release to the market would impact the supply-demand balance.

		NER	**Closure or Reductions**	**Elec. Modernisation**	**Total**
2014	*EC*	410-450m	**-**	**-**	**-**
End of Trading Period	*Ecofys*[3]	250 - 350m	250 -550m	-	**500 - 900m**
	ICIS Tschach[4]	287m	353m	31m	**671m**
	Sandbag[5]	-	-	-	**754m**
	Bloomberg[6]	-	-	-	**690 m**

<u>What will happen to the unallocated allowances under current rules?</u>

Under existing rules the unallocated allowances will be released to the market in 2020, the final year of the trading period. Their introduction to the market coupled with the back-loaded allowances (should they not be placed in the MSR) would add up to 1,800 million tonnes of ETS allowances to the already existing ETS surplus.

To avoid that all the allowances are released in one year, the EC has proposed within its MSR proposal a mechanism which spreads the surplus volume over a three year period from 2020-2022. However, the high level of allowances will slow down the effect of the MSR, thereby reducing its ability to regulate supply and restore incentives to the scheme. Spreading the release of the incentives over three years is unlikely to have a meaningful impact.

[3] http://www.ecofys.com/files/files/ecofys-2015-working-paper-leftover-allowances-phase-3-eu-ets.pdf
[4] http://www.changepartnership.org/wp-content/uploads/2014/10/Tschach-Solutions-2015-MSR-updated-with-addtional-supply.pdf
[5] http://www.sandbag.org.uk/site_media/pdfs/reports/Avoiding_the_Avalanche.pdf
[6] Bloomberg New Energy Finance, 30 March 2015

Eurogas position

While the ETS is the most cost-effective tool to reduce greenhouse gas emissions, increase the use of renewable energy sources and enhance energy efficiency, the oversupply of ETS allowances and a much lower-than-expected allowance price have weakened it as an incentive for investments in low-carbon technologies that can foster further emissions reductions in the longer term. The EC's proposal for a MSR is a sound approach to reducing a surplus of ETS allowances that jeopardises the functioning of the ETS. However, as its impact may be too little too late, the early introduction of the MSR and placement of back-loaded allowances into the reserve is needed.

For the same reasons, Eurogas proposes the following treatment of unallocated allowances:

- ***Place the unallocated allowances directly into the Market Stability Reserve.***
- ***The number of these allowances should be specified in case this may prove to be useful information when, during the review of the ETS Directive, evidence is considered to establish whether this measure enhances the risk of carbon leakage, which could be mitigated, for example, by creating and transferring the allowances into an innovation fund reserved for industry use.***
- ***For transparency, the number of unallocated allowances in the New Entrants' Reserve and the number of allowances not used due to installation closure or partial cessation should be published annually.***[7]

[7] The number of the third tranche of unallocated allowances, i.e. allowances set aside under Article 10c of the ETS Directive for investment in the power sector in certain circumstances, will only be known at the end of the trading period.

Annex

Extract from Eurogas Position Paper on the EU Emissions Trading System and Market Stability Reserve, 12 November 2014.

"The Emissions Trading System (ETS) is the most cost-effective tool to reduce Europe's greenhouse gas emissions, and at the same time increase energy efficiency and the share of renewable energy sources in the fuel mix. The current surplus of ETS allowances was generated by a number of factors, which had not been considered when the ETS legislation was adopted. This oversupply of ETS allowances has led to much lower-than-expected prices for emissions allowances, which do not provide an incentive for emissions reductions. To maintain the ETS as an optimised tool it urgently needs to be reformed, before both the market and governments lose faith in it. The concern about the impact of higher prices on EU competiveness in the absence of an equitable global agreement also needs to be addressed.

The proposed Market Stability Reserve, which allows surplus ETS allowances to be set aside until needed, is a sound measure for addressing the deficiencies of the ETS. The introduction of the Market Stability Reserve in 2021 alone is too little too late. The following four key improvements are required:

i. Introduce the Market Stability Reserve in 2017.

ii. Place the 900 million allowances that have been back-loaded straight into the Market Stability Reserve.

iii. Shorten the period from assessment of the surplus to use of the reserve from 12 months to six months.

iv. Bring forward the proposed review date from 2026 to 2022. This review must take into account the views of those parties which are actively hedging on the ETS market. "