

Oxford Energy Comment

December 2008

Europe's complex climate compromise

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Passage in less than a year of the post-2012 reforms to take the European Union's climate and renewable energy programme beyond Kyoto is a remarkable legislative feat, and a tribute to President Nicolas Sarkozy's demonic style of chairing the EU. Far less certain is whether the climate compromise, reached by EU governments at a Brussels summit on December 12 and approved by the European Parliament on December 17, improves the prospects for a global deal next year or indeed for the EU hitting its own targets in 2020.

Free allocations. The December 2008 compromise is a step backwards from the Commission's blueprint of January 2008. It is based on far more free allocations of emission allowances than the Commission proposed in its original blueprint. Less allowance auctioning will mean less auction revenue for governments and continuation of windfall profits for companies. So, in the United Nations climate negotiations, the EU will find it harder to find enough money to induce developing countries to sign up to a global agreement in a year's time in Copenhagen. However inconclusive the Poznan meeting was, developing countries did make it clear there they want money as well as technology transfer as part of any global arrangement.

The rate of auctioning of allowances, which today runs at only an average 5 % of total allocations (though up to 10 % is permissible), will rise to 60-70 % by 2020, according to Commission estimates. The Commission had proposed 100% sale of all allowances by 2020. But the December 2008 deal set as a general norm - for all

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companies outside the power sector and not at risk of carbon leakage - an auctioning rate of allowances starting at 20% in 2013, rising to 70% by 2020 and only hitting 100% by 2027. Even in 2020 the overall auction rate will be below 70% because of free allowances to offset carbon leakage (see below).

Basing itself on 100% selling of allowances, the Commission had estimated auction revenue flowing into governments' hands by 2020 at Euros 30bn-50bn a year (depending on the value of emission permits on the Emission Trading Scheme). Commission officials now reckon auctioning may bring in no more than Euros 30bn a year by 2020.

The December 2008 summit did “take note of their [EU governments’] willingness to use at least half” the auction revenue for climate change purposes. This is far from a binding commitment, and even if it were it would only involve half of a smaller amount. EU governments could commit their taxpayers to make up the shortfall in anticipated auction revenue. But they will not find this a popular promise to make during the recession of 2009 – which the key negotiations for a global accord will take place - or as easy as dipping into a large pot of auction revenue.

The emission reduction goal. Will the greater degree of free allocations directly undermine the EU goal of a 20% emissions reduction by 2020? No, formally speaking. There is to be no increase in the overall number of allowances – only a change in who reaps the benefit: more going to companies, which may be able to pass the ‘cost’ of these allowances on to customers and thereby making a windfall profit, and less to government coffers.

But more free allocations will mean the Commission doing more benchmarking, and doing it right. One wholly welcome and uncontested part of the EU reform is abandonment of the practice of national allocation in the first two phases of the ETS. No longer will individual governments decide the distribution of allowances among their companies; instead there will be EU-wide allocation, either by the market mechanism of auctioning or administrative allocation through benchmarking. If there is less reliance on market allocation through auctions, then there will be more on

benchmarking. Typically, this will involve the Commission taking the best performing technology (in emission terms) in a given sector as a benchmark, and giving companies free allowances only up to that benchmark. Companies requiring extra pollution permits beyond that level would have to buy them on the market.

Could increased free allocations indirectly undermine the 20% emission reduction target by weakening the carbon price or increasing its volatility or both? Possibly. This could happen as a result of several features of the December 2008 compromise:

- **Importing more CDM credits.** 11 member states, generally with particularly high or difficult renewable energy targets are to be allowed to import more emission credits earned outside the EU under the Clean Development Mechanism. Sweden is a good example of the rationale for this extra help. It not only has a demanding national target to reduce emissions by 17% in sectors not covered by the ETS (agriculture, transport, services). It also starts from such a high level of renewable energy today (40% of total energy use), having almost fully exploited its huge hydro-power potential, that meeting its 2020 renewable target of 49 % will be extremely difficult.
- These CDM credits will not be directly tradeable on the ETS, so they should not directly influence the ETS price. But increasing the supply of them in the EU will inevitably weaken incentives to develop renewable energy or reduce emissions inside the EU; indeed that is the whole point of importing more of them.
- **Trade of free allowances.** New member states won the right to phase in allowance auctioning in their power sector, at the rate of 30% in 2013 and rising to 100% in 2020. This concession was carefully tailored to east and central European states by stating that the phase-in of auctioning was open to states ill-connected to UCTE continental grid (such as the Baltics) or states at least 30% dependent on a single fossil fuel (coal in Poland, gas in Hungary) or states with income per head of only half the EU average (Bulgaria, Romania).

The Commission had wanted all power generators to pay for allowances, on the grounds that the greatest potential for emission cuts is in the electricity industry, and that the power industry is not exposed to international competition and can therefore pass on costs to customers without losing market share to non-EU rivals. But Poland in particular claimed immediate full auctioning of carbon allowances was economically impossible in a relatively poor country 95 % reliant on coal or lignite to make its electricity.

At the same time, however, several new member states wanted to stop their generators making windfall profits out of the free allowances. So they got written into the December 2008 compromise an option that they could prevent the free allowances from being traded on the market, in this case the ETS. Poland has indicated it intends to use this option of ‘non-tradeability’. But this could have the perverse effect of removing the incentive for efficiency for, say, companies which would otherwise be able to sell any free allowances made surplus to its emission requirements due to cleaner technology. Making such allowances ‘non-tradeable’ would reduce volume and liquidity. This might tend to raise the ETS price, but a shallower market is also a more volatile market.

- **Carbon leakage.** This is the jargon name for the problems of EU companies losing market share or jobs to dirtier rivals outside Europe. This should only be a problem if no international climate deal is agreed – but, as we have seen, the EU’s December 2008 deal slightly advances that possibility if there is insufficient EU auction money to ‘grease a deal’ at Copenhagen.

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Germany led a successful push for industries at risk of carbon leakage to be given free allowances (up to a benchmark level of the best technology in the sector). The criteria for assessing this risk have been drawn widely. “A sector or subsector is deemed to be exposed to a significant risk of carbon leakage”, EU governments agreed, if the extra direct and indirect costs of auctioning added 5 % or more to production costs *and* if non-EU trade amounted to more than 10% of the total size of that EU market (defined as domestic production

plus imports). Just in case the two metrics together failed to embrace all candidates deemed worthy of help, a further ‘either/or’ criterion for risk of carbon leakage was added to bring in companies with carbon costs adding 30% to production costs, *or* with a non-EU trade intensity or exposure of 30%. So widely have these criteria been drawn that the Commission estimates they embrace 90 % of all EU manufacturing. This is surprising, and faintly ridiculous, given that in a regional trading bloc of 27 countries many smaller countries and most smaller companies do virtually all their trade within the EU.

How many of these free offset allowances for carbon leakage will end up on the market? If a company truly faces a real risk of carbon leakage, there should be no problem about windfall profits, because the company in question would not dare pass on the allowances’ cost for fear of losing custom to non-EU rivals. In these circumstances, there is no reason to make these offset allowances ‘ non-tradeable’, because there is not much likelihood they will be offered for sale. But because the terms for offsetting carbon leakage – in the event that there is no global agreement – are potentially so generous, the odds of some abuse are high, with companies either passing the ‘opportunity’ costs of free allowances to customers or selling free allowances to the market.

None of these features of the EU compromise can confidently be said to have a conclusive impact one way or the other on the future carbon price. But together they do underline the uncertainty and probable volatility of the carbon price, which needs to provide a steady signal for long term investment. However, some cures could be worse than the disease. The Brussels summit was probably wise to ignore Poland’s recipe for stabilising the ETS price by keeping it within a corridor or band. This would have involved member states being given the right to add/subtract allowances or speed up/slow down the rate of allowance auctions. This would have been akin to central bank intervention in the money supply or foreign exchanges to influence interest or exchange rates, except that in this case it would be as if the euro were managed by the eurozone’s 16 national banks, not the European Central Bank.

Any added uncertainty about the ETS has implications for other features of the EU new climate and energy reforms:

Carbon capture and storage subsidies. One is the decision to use 300m emission allowances (out of a new entrants reserve) to subsidise demonstration projects of carbon capture and storage (CCS) technology. The aim is to have around a dozen such projects up and running within a few years. But since governments are loath to pledge any taxpayers money at the moment, a future raid on the larder of ETS allowances seemed a good solution. And even though recession has pushed the ETS price lower, 300m allowances would still be worth around Euros 4.5bn at December 2008 rates. In theory, now there is legislation enshrining this subsidy in law, potential CCS operators could go to a bank and easily raise finance on the back of it. In practice, bankers, particularly in present circumstances, will have to weigh carefully the future value of ETS permits as collateral value for their loans, and they may not be reassured by the December 2008 EU deal.

Renewables. Any new uncertainty about the ETS makes the existence of a separate 20% renewable energy target for the EU look like wise insurance against the ETS not delivering all its intended emission cuts. Many economists had argued that it would have been more efficient to rely on just one target for emissions reduction, and setting a separate goal for renewable would be counter-productive. The main electricity generators also complained at part of their market being artificially ‘cordoned off’ for green power. But to the energy security and technology justifications for a separate renewable target, the argument of prudence can now be added.

Targets without flexible trading. One big caveat remains about renewables. EU legislators adopted the differentiated national targets for the 27 member states almost exactly as the Commission first proposed – but not the flexible trading system that was designed to go with the targets. This matters because the targets are deliberately out of kilter with countries’ renewable potential. They were intentionally set below the green potential of poorer new member states, and above the green potential of richer old member states – so that the latter would have to buy green power from the latter.

In the event, countries such as Germany and Spain were adamant in their opposition to any EU-wide renewable trading scheme under which they might lose control of their successful national support schemes. So renewable energy trading will be tightly controlled by governments. Governments can pair up to buy and sell statistical shares of green power, and organise joint renewable projects, among themselves. But in renewable energy there will not be what most people would recognise as a market.

The market approach takes a mauling. Perhaps it should no be surprise that governments are rigging the renewables and emissions markets to suit themselves. After all, they created these markets in the first place. But increasing intervention risks undermining the market approach and, in emissions, improving the case for a carbon tax to provide the price/cost certainty that the ETS cap-and-trade system cannot. Industry, whether Polish coal or German machine tools, won major concessions in the December 2008 compromise, but may come to regret its complicity with governments in giving the market approach a mauling.