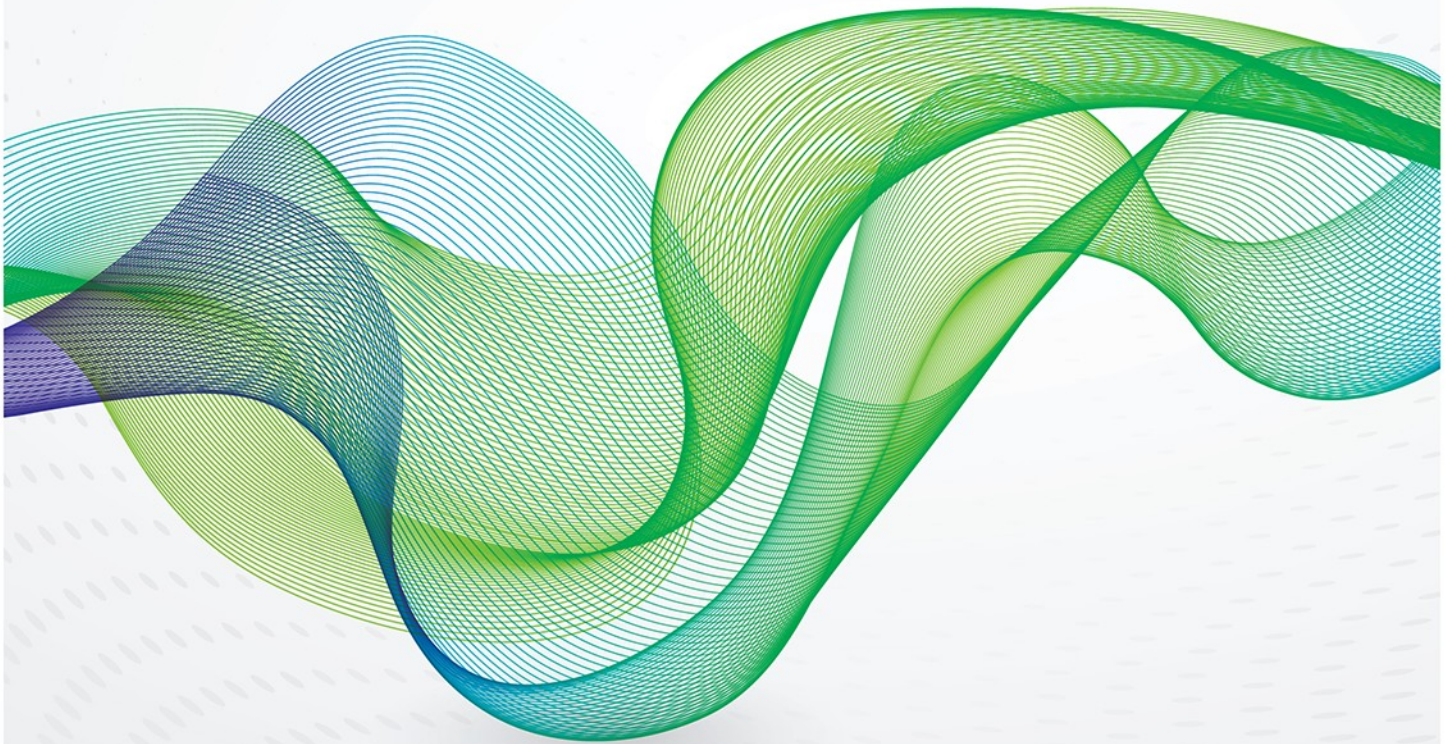


January 2014

The EU's new energy and climate goals for 2030: under-ambitious and over-bearing?



Introduction

On January 22 the European Commission presented a Communication setting out its package of proposals for the future of EU energy and climate policy after 2020 when current legislation expires¹. The Commission aims to provide policy certainty to low-carbon investors up to 2030 and to set a goal for EU emissions reduction by 2030 as Europe's contribution to global climate negotiations next year, in a way that also deals with problems that have arisen with Brussels' two favourite policy instruments – the Emissions Trading System and the Internal Energy Market programme – since the first energy and climate package was agreed in 2009.

The EU is more or less on track to meet its 2020 binding targets of a 20 per cent emissions reduction (compared to 1990) and a 20 per cent renewable share in total energy consumption, and only falling short on its aspiration of a 20 per cent energy saving (relative to business-as-usual projections of consumption over the 2005-2020 period). However, the Commission is doing far more than just rolling over its current policies. For it also seeks to deal with the growing controversies since 2009 about renewables' impact on the stability and cost of Europe's electricity and about rising energy prices' effect on Europe's international competitiveness. But the Commission's proposed solution to some of these issues looks likely to stir fresh controversy, both technical and political. Much of this will emerge by the time EU heads of government come to give their views on these proposals in March.

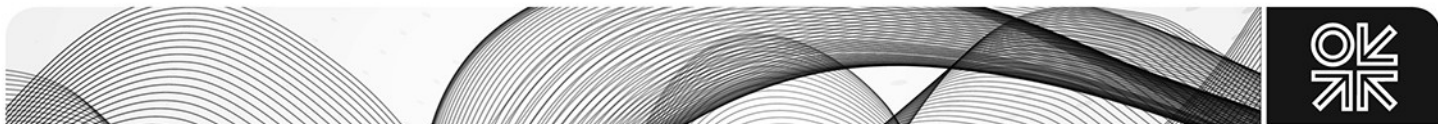
A single target?

The first question the Commission had to answer was whether to repeat the 2009 exercise in setting two equally binding targets – one on cutting emissions and the other on increasing renewables – or go for a single target. There was never any doubt that any single target would be for emissions reduction; cutting greenhouse gases in the atmosphere is what this is all about. Nor did the Commission have too much trouble in deciding to go for a 40 per cent reduction in GHGs by 2030. While some smaller member states, especially in eastern Europe, wanted a figure lower than 40 per cent – and none of the EU's 28 member states wanted a higher goal, the biggest EU member states had already pronounced themselves in favour of 40 per cent. In the Commission itself, the president, Jose Manuel Barroso, joined the climate commissioner, Connie Hedegaard, to prevail over the energy commissioner, Gunther Oettinger; out of concern about rising energy costs and exposed to the full weight of industry lobbying from his home country of Germany, he had argued for 35 per cent. In terms of climate policy, he was not supported in this by the Commission's own internal analysis in relation to the EU's longer term goal of reducing emissions by 80-95 per cent in 2050 compared to 1990. This projected that, whereas a 40 per cent reduction would put the EU on a "cost-effective track" to achieving the 2050 goal, a 35 per cent reduction target for 2030 would entail "additional costs over the entire period up to 2050, while having lower costs in a 2030 perspective".²

Mr Barroso has expressed confidence he can get EU governments and the European Parliament to endorse a 40 per cent emission reduction target for 2030. He can draw on Commission modelling showing that even current policies, if they achieve the desired effects, would deliver a 32 per cent emission reduction by 2030. Nonetheless, a 40 per cent target would be seen by some as quite ambitious, particularly as the Commission proposes it would be achieved entirely within the EU, without Europe making up any shortfall by buying any foreign carbon allowances, as was permitted in the now-defunct Kyoto system and is still permitted under current EU policy. While a 40 per cent target may be negotiable within the EU, getting Europe's partners to match it in an international climate agreement would certainly be harder.

¹ A policy framework for climate and energy in the period from 2020 to 2030, COM (2014) 15 final.

² Summary of the impact assessment, page 13.



But from an environmental perspective the target can be seen as a retreat from the EU's goal of a reduction of 80-95 per cent by 2050. 2030 is, after all, already two thirds of the way through the period 1990-2050, yet the Commission is only proposing to get half way towards the target (an approach which has been described as "walk now; sprint later"). Furthermore, most commentators agree that the early reductions, in such areas as electricity generation, however difficult they might seem at the time, are likely to be much easier to achieve than comparable deep reductions in areas like transport (largely dependent on oil) and industry. It is this sort of logic that has led the Climate Change Committee in the UK to argue that under the UK's fourth carbon budget for the period 2023 to 2027 "emissions [must] be reduced by 50 per cent on 1990 levels in 2025". From this perspective, the proposed EU target of 40 per cent by 2030 looks quite modest.

The Commission seems to have no clear idea how the big reductions in the period after 2030 are going to be achieved. In transport, biofuels no longer look like an easy solution; electric vehicles may prove important but it is too early to be sure about the ultimate potential, especially if the pressure for decarbonisation is not maintained. In industry, the Commission itself says that carbon capture and storage "may be the only option" but recent difficulties with the technology suggest that it may be risky to rely on it as magic bullet.

So environmental logic would suggest that a more ambitious target for 2030 is needed both to underpin the longer term target and to maintain the pressure for technology development. The Commission has not presented any economic argument for not adopting a higher target; nor is it suggesting that the longer term decarbonisation goal should be modified for cost reasons. Indeed, it still argues that "the costs of a low carbon transition do not differ substantially from the costs that will be incurred in any event". So the relatively modest target for 2030 seems to be mainly a response to political developments and the apparent lack of enthusiasm among member states for a more ambitious approach. It therefore runs the risk of undermining investors' confidence about the EU's commitment to its longer term goals, rather than strengthening it.

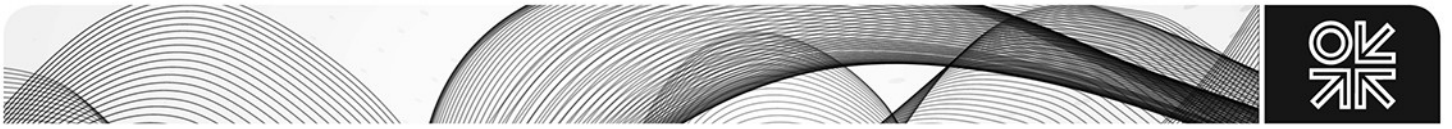
The move in the direction of a single overall target may reinforce these doubts, but more because of questions about the likely effectiveness of enforcement than because of any problems of principle. The change is logical in itself: a single target leaves more flexibility for member states to choose the most efficient policies. Ed Davey, Secretary of State for Energy and Climate Change for the UK, which is trying to rebuild its nuclear sector, has welcomed the move on this basis. Getting away from sub-targets could in principle enable the development of more technology-neutral approaches (like carbon intensity targets for electricity) or open the way for a strengthening of the ETS, and possibly for better links (even ultimately some sort of trading?) between the ETS sector and non ETS markets, thus keeping the focus directly on emissions and avoiding the possible distortions which arise from arbitrary targets in particular sectors. In fact the Commission is not going quite this far.

The sectoral targets and the ETS

As regards the ETS sector (the largest emitters), the Communication suggests that it should deliver a reduction of 43 per cent by 2030 on 2005 levels; this would imply annual reductions of 2.2 per cent per annum after 2020, as compared with 1.74 per cent pa today. The limit would be enforced in broadly the same way as at present, though the Communication puts forward a range of measures (discussed below) to make the system more effective.

The non-ETS sector (smaller emitters) would have to make a reduction of 30% on 2005 levels overall. The target would be allocated and enforced at national level through the new governance procedures described below. There is however no proposal to link the ETS and non-ETS sectors. There are, of course, significant practical difficulties in linking the sectors or treating them in the same fashion. Nonetheless, given the different means of enforcement and the different targets for the sectors there is scope for possible distortions as between them – it is not necessarily clear that the most cost-effective savings will always be selected.

Nonetheless, keeping the focus on emissions alone, via these targets, would have the merit of simplicity and certainty. The multiplication of targets can lead to unintended consequences. Given



that the EU's main instrument for emission reduction is the ETS, there has always been a clear theoretical argument against adding any targets for renewable energy and energy efficiency. Progress in these two areas automatically reduces the demand for carbon allowances on the ETS, lowers the prices of traded allowances and therefore blunts the effectiveness of the ETS in penalising hydrocarbon fuels and in promoting carbon-free alternatives. With the success in particular of renewables, this is what has been happening, although economic recession and the admission of non-EU carbon allowances or credits into the ETS have been far more influential than EU renewables in depressing the ETS price. (However, the corollary is that without targets the rate of renewables investment would almost certainly have been much lower. Indeed it is doubtful if the ETS could ever be the primary instrument in promoting renewables, if that is taken as an aim in itself).

The Commission effectively despairs of removing excess allowances from the ETS until 2020, despite recent EU agreement on 'back loading' which will take some allowances out of the system in the next couple of years but put them back towards the end of this decade. But from 2021 on it is proposing a system that would automatically regulate carbon allowance liquidity in the ETS. This would be done by creating 'a market stability reserve'. Allowances would put into the reserve in times of excess liquidity, and returned to the market at times of tighter liquidity. Keen to allay carbon traders' fears about political interference, the Commission stresses that this would take place under pre-defined rules that would leave no discretion to the Commission or member states in implementation.

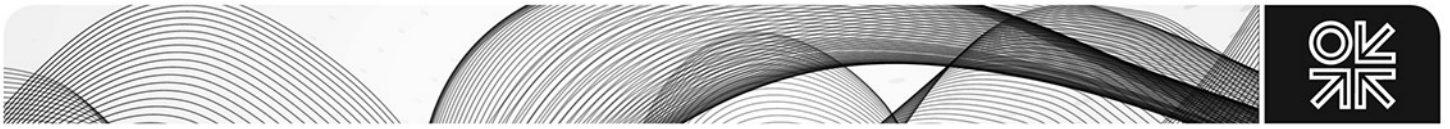
Despite this reserve's effect in smoothing the supply of allowances, it is not clear that the problems of the ETS have been solved. In particular, ETS carbon prices could be greatly influenced by the existence, or absence, of renewable and energy efficiency targets as well as by the various economic uncertainties which have affected them in the past. According to the Commission's impact assessment, the ETS price could be as low as € 11 per allowance by 2030 if the EU sets itself ambitious renewable and efficiency targets in addition to an emission reduction target or, in the absence of these two extra targets, as high as € 53 per tonne of carbon. The latter price would seem to be the answer to many people's prayers: a carbon price that shifts generators out of coal and into gas, and produces a more cost-effective path to decarbonisation than many of today's very expensive renewable or energy saving schemes.

However, the same theoretical projection was made in 2008-9, and was rejected in favour of adding ambitious renewable and efficiency targets in a belt and braces approach – just in case the ETS didn't work. And it didn't.

The right kind of renewable target for 2030?

Perhaps because of this experience, the Commission is again proposing a renewables target, though this time of a rather different sort: "an EU-wide binding target" to raise the share of renewables to "at least 27 per cent" of energy consumption by 2030 (which would imply that about 50% of electricity was renewable). It says it is doing this chiefly because the renewables industry creates benefits, unrelated to emissions, in terms of energy trade balances, reliance on indigenous resources, jobs and growth. But this target provokes three questions.

The first is why a renewables target at all? The logic of the "single target" approach is to focus on the ultimate target of emissions reduction and leave flexibility about the choice of method. The retention of a renewables target suggests, perhaps worryingly, that the Commission lacks confidence in its overall approach or is imposing a target for the (rather contentious) reasons of industrial policy suggested above. The second question is about the level, on the assumption that a target is still needed - why only 27%, when the Commission's projection is that the EU is already on course to achieve a 24% renewable share of energy by 2030? The third is about the so-called binding nature of the target. Under current policy, the EU has a binding renewable target of 20% by 2020. But this is only a notional average of the performance of 28 EU states; the binding part is the individual renewable target given each EU state, written into legislation and policed by the Commission (and, possibly eventually, the European Court of Justice which can impose fines on states for non-compliance with EU legislation). By contrast, the 27% renewable goal would not be translated into



national targets. But how can the EU bind itself, when there is no legally superior body to do the binding or to impose sanctions in the event of non-compliance?

The proposed new governance structure

The answer to the Commission's use of the word 'binding' in this context seems to be that it wants to put muscle into what it calls "a new governance framework based on national plans for competitive, secure and sustainable energy"³. The Commission says the aim is to ensure EU climate and energy goals are delivered, provide greater coherence between member states' approaches, promote energy market integration and competition, and provide certainty to investors. The idea is borrowed from what has recently been happening in economic and fiscal policy via the so-called European Semester process. At the start of every year the Commission draws up overall policy objectives that get broadly endorsed at a spring summit of EU leaders; governments then submit their short and medium term fiscal plans; the Commission then checks whether these plans are in line with the EU objectives, and if they are not so aligned issues recommendations to errant governments by mid-year. The Commission now envisages a similar process to increase "EU coordination and surveillance" in energy and climate policy, with the Commission issuing "detailed guidance" for national plans which governments then prepare and present to the Commission which assesses them.

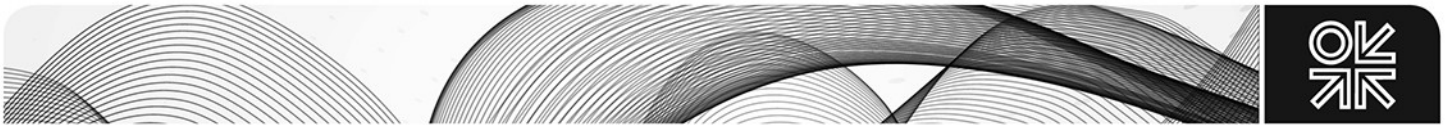
The European Semester process has serious drivers in the shape of the Eurozone crisis, Germany's insistence on fiscal rigour among its fellow Eurozone members if they are to get any financial aid from Berlin, and Eurozone members' acute awareness that they can at any moment be hammered in bond markets for any fiscal laxity. As a result, the 18 EU members which belong to the Eurozone pay at least lip service to Commission recommendations, but non-Eurozone countries like the UK do not. Whether this system can be translated to all 28 EU states in energy and climate policy, where there is no instant danger for governments in letting their national policies stray from the EU line, is very doubtful.

There are also greater technical difficulties than with the Semester process – in relation to climate change, the EU is dealing with long term goals and inevitably dependent on projections and assumptions, none of which can ultimately be proved or disproved, in assessing how adequate member states' proposals are in relation to those goals. There is always the risk – as has sometimes been alleged in relation to the Semester process – that the proposed governance structure will be effective in relation to smaller member states, who are less able to challenge the Commission's analysis or resist its proposals, while having little impact on larger member states.

So it is not clear how much impact the proposed new system might have in enforcing the so-called binding targets – and no doubt this is why the Commission suggests that "the governance structure may need to be set in legislation at a later date if the envisaged cooperative approach is not effective". However, this would be a major step towards increased powers for the EU and the Commission in relation to energy and would no doubt be resisted by member states, which have jealously guarded their right to determine their own energy mix. The Communication does not explain why there would be a willingness across the EU to go along with such legislation – especially given that the scenario envisaged is one where member states are in any event unwilling to go along with the Commission's ideas. There is also a political dimension; European Parliament elections are coming up and these could return more MEPs sceptical about the idea of a Europe run from Brussels. The proposed governance structure risks being seen as either ineffective or intrusive (or even both).

However, the Commission is in the institutional business of asserting the European dimension of policy. The catalyst for its new governance idea is to regain some control over the national renewable subsidy schemes that all EU states have and the back-up capacity mechanisms that many EU states either have or plan. It worries that these renewable and capacity schemes are fragmenting the internal energy market faster than Brussels can knit the 28 national markets together with cross-

³ Press release, January 22 2014, IP/14/54



border infrastructure and cross-border trading arrangements. It has already had a first go at persuasion by issuing guidelines on national intervention in electricity markets last autumn⁴, and it has made clear it will try to use new state aid rules to steer renewable and capacity schemes in a more cost-effective (i.e. more European) direction. Control of state aid is an area where the Commission can act almost autonomously (subject only to the European Court of Justice jurisdiction), though the Commission may be pushing its luck with its new draft state aid rules for energy and environment that appear to be so prescriptive on renewable and capacity schemes that they really ought to be presented to European governments and parliament to pass through legislation (which the Commission cannot do on its own).

Conclusions

In some ways the Commission's proposals represent progress towards a simpler and more effective approach to meeting climate change goals – focusing directly on the emissions which give rise to the problem. But it has not taken the approach to its logical conclusion, of a single overall goal covering all sectors and enabling the most cost-effective measures to be implemented whatever and wherever they might be; nor has it come up with convincing solutions to the problem of enforcement of the targets and strengthening the ETS to ensure its effectiveness. For the next few years, the Commission will have to rely significantly on its state aid powers to reshape EU energy policy. Its energy and climate governance framework may be something that the EU will eventually need to adopt, possibly in some future EU treaty renegotiation. For the moment, however, it looks like political overkill; even as they stand, with potential gaps in enforcement, the 2030 proposals may raise problems for member states.

Yet without legislative backing, the new approach could well lack teeth and credibility; the modest scale of the 2030 target suggests something of a retreat from the longer term goal, and the downgrading of the renewables target implies that the EU is prepared to slow down the pace of development in this area. There is also some ambiguity in the Communication about whether concerns about Europe's international competitiveness should influence strategy and could prevail over climate objectives. On the one hand the Commission argues that the emissions targets are "in our own self interest"; on the other, the Communication includes the rather obscure passage "the proposed target for 2030 is achievable. Continuous appraisal will, however, be important to take account of the international dimension and to ensure that the Union continues to follow the least cost pathway to a low-carbon economy", which rather implies that concerns about competitiveness remain and may affect future action. Against this background of uncertainty about whether the EU is seriously committed to its long term target, and whether it has the means to deliver its objectives, it is doubtful if investor confidence, on which the Commission lays so much store, can be maintained.

⁴ OIES comment, November 2013, Limiting state intervention in Europe's electricity market.