

CEPS COMMENTARY



Thinking ahead for Europe

Climate Change: Balancing economic and environmental concerns

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On 10 September 2014, Jean-Claude Juncker presented his team of Commissioners. In his mission letter to Commissioner-designate Arias Cañete, the Commission President made clear that climate change remains a critical priority for EU policy and referred directly to a number of elements on which he wishes the Commissioner to focus during his term.

These focus areas include the 2030 framework for climate and energy policies, and his desire to proceed with legislative proposals at an early stage, providing leadership in the international debate and negotiations, with the 2015 agreement as an important milestone. Finally, Juncker called for the strengthening of the EU Emissions Trading System (ETS) as an instrument to achieve climate-change targets in a cost-effective way.

These instructions come in the aftermath of very serious economic and financial challenges for the EU, where the perception is that while climate change remains an important element, the focus has shifted from climate change policy per se, to integrating climate and energy policy and to promoting EU jobs and competitiveness.

The new mandate also comes at a time of important challenges, with the EU ETS being perceived as falling short in delivering reductions due to the low price of CO₂ and of continuing changes in the design of the system, which for various reasons are not fixing the problem. The tough battle fought to introduce backloading, a piece of legislation that was intended to provide temporary relief, is just one example of the scepticism with which the EU ETS is regarded, and the reception that measures to 'fix it' have received, and may receive in the future.

The EU ETS and its future lay at the heart of the 2030 package that the European Commission put forward in January 2014. It is an ambitious and complex vision with many components. The timing and relationship between them are critical. The debate over the number and nature of targets, provisions to address carbon leakage and competitiveness will be closely intertwined with the development of the energy union and energy market.

The EU has prided itself on the leadership that it has shown in international negotiations, including at the Copenhagen UN Climate Change Conference, which failed to deliver a new

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international climate change agreement. Yet, while applauding the effort at leadership, some stakeholders in the EU seem to question the rationale and its delivery.

What went wrong?

The package that was passed in 2008-09 continued the vision of the EU ETS as the central pillar of EU climate change policy. Together with the three targets on GHG reductions, renewable energy and energy efficiency, it formed the core of the EU's approach to addressing climate change through a well-balanced package.

The change to a low-carbon economy was intended to be driven by carbon prices through the EU ETS. However, prices in the EU ETS dropped significantly after the economic crisis – to a low of €4-6 per tonne of CO₂ emitted from a €17-20 in the preceding period – resulting in a loss of confidence: Can the EU ETS deliver the price signal to reach the 80-90% reduction in GHGs by 2050, which is the EU's objective?

The low prices resulted from a number of causes: low CO₂ emissions compared to the level predicted when the 2020 package was approved; the significant number of international credits that entered the system; the mitigation actions of covered installations; and finally the overlap with RE (renewal energy) and EE (energy efficiency policies in the EU. In 2008, a report to the European Commission¹ projected total GHG emissions in 2010 to be 5,226 MtCO_{2e}. Actual 2010 GHG emissions, according to Eurostat, were 4,751 MtCO_{2e}. In the case of the EU ETS, actual emissions in 2010 were 1,939 MtCO₂, which compared to a calculated projection of 2,132 MtCO₂.

The low price also revealed root problems that were present, but not visible. The EU ETS, which is a set of rules that are designed to allow a regulatory market (the EU ETS) to behave as a market for a real and tangible commodity, allowed for the natural elasticity of demand to function. Demand for EUAs (EU emission allowances) is dependent on emissions in the EU, which in turn are heavily dependent on economic performance.

In order to respond to demands for predictability from industry stakeholders, and demands for environmental integrity from the green stakeholders, the design of the EU ETS did not include any provision to allow for elasticity of supply. Supply comes to the EU ETS market in two ways: through free allocation, for those sectors that are deemed to be at risk of carbon leakage; and through auctioning. Broadly speaking, carbon leakage can be defined as the displacement of economic activities and/or changes in investment patterns, that directly or indirectly cause GHG emissions to be displaced from a jurisdiction with GHG constraints, to another jurisdiction, with no or less GHG constraints.

Neither supply channel incorporates elasticity of supply. Free allocation is based on historical levels of production from a period divorced from the harsh realities of the economic crisis, while the auctioned amounts were fixed to 2020 through the auctioning schedule of EUAs. The auctioned schedule, i.e. the amounts auctioned during the trading period at precise dates, is fixed at the start of the trading period and also insulated from the realities of demand.

The low EUA price has been identified as the 'problem'. The price cannot be a problem in a market approach; the problem is the lack of flexibility on the supply side, and the absence of any governance provisions to address such issues in a timely manner.

¹ "Model-based Analysis of the 2008 EU Policy Package on Climate Change and Renewables", P. Capros, L. Mantzos, V. Papandreou, N. Tasios, Report for the European Commission, June 2008 (ec.europa.eu/clima/policies/package/docs/analysis_en.pdf).

The second critical issue is competitiveness, and the impact of carbon prices on competitiveness. Carbon cost, i.e. what industry pays in reaction to the carbon price, is dependent on whether a sector is deemed to be at risk of carbon leakage, and included on the carbon leakage list, in which case it gets a significant part of its emissions in the form of free allocation.

While there is clarity on how carbon leakage risk is addressed to 2020 (through the Carbon Leakage List), there is no provision for post-2020 measures. Industries that are exposed to global competition and covered by the EU ETS are anxious that measures on how carbon-leakage risk is to be mitigated after 2020 are expeditiously made clear.

The timing (in parallel or sequentially) of how the price of carbon (currently seen as too low) and competitiveness (in the form of carbon cost) are to be addressed have emerged as the most critical items.

Finally, the EU, like all Parties to the UN Framework Convention on Climate Change (UNFCCC), is preparing for the new global climate change agreement that is to be finalised in Paris in December 2015. As at the failed attempt to reach an agreement at the Copenhagen Climate Change Conference in 2009, many in the EU feel that the EU should lead, and put on the table an ambitious target, expressed through the elements in the framework for the EU's 2030 Climate and Energy policies.

However, an increasing number of stakeholders are questioning this approach and the argument that the EU, with about 10% of global emissions, needs to lead. 'Is this approach good for the EU and why', are the questions being asked. The issue of competitiveness is very much linked to this argument – how long can the EU take the lead, without inflicting continuous damage to its industrial base?

What needs to be done?

The approach proposed in the European Commission's January 2014 package is sound overall, but it needs to be put in a context where the causes and symptoms are correctly identified. Other important elements are timing and governance. What does this mean in practical terms?

- Timing, speed and process are important in order to restore confidence in the EU ETS. Identifying design flaws, such as those discussed above, and fixing them through 'no regrets' measures at the earliest possible time, will help restore confidence.
- The long-term perspective of climate change policy must be emphasised, especially for the EU ETS, by examining the need for long-term targets and how to best match those with trading periods.
- There is a need to identify and address competitive concerns resulting from asymmetrical climate change policies being implemented by the EU in comparison to other major trading partners. This would include timely and convincing reassurance on carbon-leakage provisions post-2020. It must be recognised that free allocation cannot be a long-term solution in the de-carbonisation scenario calling for 80% reduction in greenhouse gases by 2050. International cooperation with main economic partners needs to be explored and efforts in other jurisdictions that have carbon-pricing mechanisms should be closely monitored. The fundamental decision needs to be made whether carbon-leakage risk measures are compensatory in nature (that is, they are intended to compensate for additional costs as a result of carbon as long as the asymmetry lasts) or transitional (provide assistance during a transition period while industry adapts to a new lower-carbon society).

- The Paris 2015 agreement will need to contain provisions on transparency of mitigation and implementation that will reassure EU competitiveness concerns, and stakeholders need to be convinced of the rationale for EU leadership. Competitiveness is an issue that is currently absent from the international discussions and cannot be avoided.