

CEPS COMMENTARY



Thinking ahead for Europe

EU Climate and Energy Governance: There's more to it than meets the eye

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Governance has suddenly become a hot topic in the EU, although one that is not necessarily well understood and whose discussion so far is largely confined to experts from the EU institutions, member states and stakeholders. Governance is an immensely complex task. One definition describes it as the “establishment of policies, and continuous monitoring of their proper implementation, by the members of the governing body of an organisation”.¹ In the context of EU climate and energy policy, it broadly relates to, among many other issues, how and by whom are objectives formulated and who is responsible for determining whether they have been achieved, for reporting on their achievement and for ensuring compliance.

Areas of governance

EU energy and climate governance covers a wide diversity of issues ranging from the macro EU level to the way in which markets are run and managed. It certainly goes beyond the issues that are identified in the 2030 framework for climate and energy and the Energy Union.

A reliable system of climate and energy governance in the EU would consist of at least seven areas, which we outline below. Although there may be a sense that such a system has recently been put in place, it is necessary to provide a comprehensive list that will allow for a good understanding of how complex and interrelated these various elements are. In order to ensure that these issues are dealt with in an integrated manner, we recommend that the European Commission creates a roadmap – possibly in the form of a Communication – that would indicate the direction, interactions and a timeline for adoption.

¹ <http://www.businessdictionary.com/definition/governance.html#ixzz3fm193HLQ>

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1) *Interaction between policy instruments*

The interaction between the instruments to address the main objectives of the EU energy and climate package is of significant importance, as shown by the current overhang in the EU emissions trading system (ETS), which is primarily the result of erroneous demand expectations. How should this relationship be managed? It is hoped that the Market Stability Reserve (MSR) will provide part of the answer. This means that the MSR will become a central element of governance, once the MSR is adopted.

In more general terms, this area will include the relationship between the instruments used to achieve a long-term carbon-price signal, such as the EU ETS, to ensure that cost and competitiveness and the risk of carbon leakage is correctly managed (e.g. renewables integration and support, free allocation and state aid issues). This is also true for security of energy supply and the internal energy market.

It would also include how the interaction between the carbon market, other policies and measures and the electricity market is governed. At a minimum, its governance should be flexible and take into account the governance enshrined in EU treaties as well as market realities.

2) *Role of markets*

The role that markets (electricity and carbon markets) play or should play becomes an important issue. What is the role of the ETS and what is the role of the internal energy market in decarbonisation? What will be the role of the so-called 'energy-only' market?

Behind these questions is the issue of whether there is a need for complementary instruments to existing market functioning and how such relationships can be governed. It may be instructive to also look to experiences outside the EU. For example, in California, the ETS is residual while energy policy leads, whereas in the EU, the main focus has so far been on climate policy.

In the last 15 years, gas and renewables accounted for 91% of new capacity. Yet, investment decisions affecting the technology associated with these two energy sources have not been triggered in the same way. So far, EU member states have primarily relied on dedicated policy instruments to support the deployment of renewables. Thus, while the stated governance was market-based, these investments have mostly been spurred by triggers other than price signals based on internal energy market regulation and the EU ETS. Given the changed circumstances, member states are exploring ideas on how to make better use of the market in order to integrate renewables, which is seen as an indispensable mechanism to organise an increasingly decentralised electricity system.

3) *Governance of markets*

Markets need stability and predictability. However, this must not be mistaken for rigidity and lack of responsiveness to changing conditions, especially within a timeframe that is relevant and responsive to market realities.

How can the EU's broader governance be adapted to a governance of the instruments in the 2030 framework and the Energy Union to be able to observe the constraints and realities of the EU while responding to market realities that move at a different speed? How change is managed, especially in regulatory markets, is important as illustrated by recent experience. What gets enshrined in directives and what is put in regulation makes a significant difference in the governance of the market and its components. The change of EU ETS parameters does not always have to be subject to co-decision, as this creates uncertainty and gridlock.

4) *Targets and responsibilities*

An important debate is the role of targets, notably the difference between legally-binding obligations based on EU policies and targets (e.g. the EU ETS or the 2009 Renewables Directive) and indicative targets, which express an ambition or direction. The legally binding targets are binding EU laws, enforceable by the European Commission and the Court of Justice of the European Union.

Some member states in the European Council have indicated that they do not want legally binding targets, i.e. targets that can be enforced. The conclusion would be that the EU will need to look beyond targets and focus for instance on improving investment conditions by offering cost-effective financing mechanisms.

If that is the case, responsibility will fall to the member states to indicate ways to improve co-operation, which will become essential for an efficient integration of renewables and for reaching the overall target. This would mean giving a real meaning to regional energy policy co-operation (see Egenhofer, Dimitrova and Popov, 2015). Recent initiatives offer good opportunities to reinforce such co-operation.² It is important for the governance discussion that the EU or the European Commission gives guidance on regional co-operation (see De Jong & Egenhofer, 2014). Other complementary mechanisms, such as EU-level tenders may also provide options that ought to be examined.

5) *Funding instruments*

The role of the ETS-related funds, NER 300/400 and the Modernisation Fund cannot be over-emphasised. Effective governance, based on their objectives and lessons learned, will be critical if they are to be a success. At EUA prices higher than €20, the amount available from the NER400 funds would amount to € 8 billion per annum for low-carbon projects (including industrial projects for the first time). While the potential impact of such a large fund may be reason for optimism, it also warrants a review of the roles that various institutions play in operating the fund.

Investment in infrastructure (i.e. for renewables integration, smart and flexible grids, etc.) and energy efficiency are essential. However, the level of investment notably in infrastructure in the European Union has fallen considerably, due to the financial crisis and the ensuing economic stagnation of the EU.

EU funds will be able to play their role and increase investments in these areas only if a number of conditions are met, some of them related to governance. One would think that better use of cost-benefit analyses or a better Ten-Year Network Development Plan (TYNDP) would facilitate funding considerably.

First, the creation of an investment-friendly environment in the energy sector is required, removing institutional and regulatory barriers that are unfit for a new, more decentralised and more integrated system. Second, the EU (and member states) can offer financial and fiscal incentives (possibly with some guaranteed certainty). This will necessitate the design of a stable and predictable framework that is as depoliticised as much as possible.

² See e.g. "Joint declaration for Regional Cooperation on Security of Electricity Supply in the framework of the internal market" by 12 member states 8 June 2015); Pentalateral Energy Forum: Second Political Declaration of the Pentalateral Energy Forum of 8 June 2015; Egenhofer, Dimitrova and Popov (2015).

6) *Role of the European institutions and the member states*

Turning to the institutional aspects, an important issue is the respective roles of the European institutions. Ultimately it is the responsibility of the European Commission as the guardian of the Treaty to ensure that the EU's aspirations and objectives are achieved.

Much will depend on the outcome from the legislation, notably the legislation on market design³ but also the renewables Directive (see Wyns et al., 2014). Depending on how much of the obligations will be legally binding, reporting and monitoring mechanisms will need to be adopted.

These mechanisms could be developed, for example, in the context of integrated national energy and climate plans. The European Commission might think about developing templates to ensure transparency and comparability, for example, as has been done for the National Allocation Plans I in the ETS phases I⁴ and II.

Other instruments exist, such as the State of the Energy Union report, the first of which expected by the end of 2015. Such reports can be useful but they depend very much on whether there is a consensus. If member states disagree, such reports will not be able to make a big change.⁵ Nevertheless, the European Commission could use the State of the Energy Union report to clearly cite the shortcomings and barriers towards its energy and climate targets, although it might prefer not to do so.

Of particular importance will be the update on the State Aid Guidelines, and the structural reform of the ETS. In this context the annual State of the EU ETS report would also be a great opportunity and instrument and become an integral part of the governance.

An important question concerns the role of the European Parliament, especially its role in developing the governance system, but also in overseeing its implementation and enforcement.

7) *Energy Union and the role of climate and energy policy, respectively*

In its broadest interpretation, governance must be seen as the relationship between the 2030 framework for climate and energy and the Energy Union. This starkly raises the question of the relationship between climate and energy policy. Fundamentally, while energy is a significant dimension of the climate issue, the two are not interchangeable. Addressing climate change as a separate and independent policy area is legitimate, but the two areas are deeply intertwined.

³ See forthcoming CEPS Energy Climate House Task Force Report on market design by Genoese & Egenhofer (forthcoming)

⁴ A template can be an important element for monitoring and reporting, which, if properly done, can be effective in demonstrating whether the policy works or not. The transparency and comparability of outcomes of national allocation have made member states accept that more centralisation will be required in the future. This acceptance triggered the changes to the ETS in the 2007-09 Climate and Energy Package.

⁵ For example, the First Strategic Energy Review (European Commission, 2007), which led to the 2007-09 Climate and Energy Package was published in a time when there was a consensus on the need to move on with climate policy. The Second Strategic Energy Review (European Commission, 2008), which also was the last one saw far less agreement among member states and consequently had less impact.

Conclusions

The outcome of the debate on governance should be judged by the extent to which the EU and the member states are able to develop a framework that creates confidence for investors. This does not necessarily translate into nationally binding targets. Such a broader approach is warranted due to the changes that have occurred since 2007-09, when the last climate and energy package was adopted. The European Commission's State of the Energy Union report could provide a framework for this approach, provided that the European Commission chooses to clearly identify shortcomings and barriers and those responsible for erecting the barriers.

The EU is effective in finding compromises when it comes to resolving differences in substance. It is less effective when it comes to dealing with institutional struggles. There is a risk that a compromise is reached at the end that reflects a truce between the institutions but that does little to address the challenge to integrate renewables.

EU climate and energy governance is about creating an adequate mechanism to ensure that the EU moves towards achieving its climate and energy targets, notably for renewable sources of energy. It aims to create a framework that generates the necessary market-induced investments.

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