

## **Backloading: A necessary, but not sufficient first step**

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This report was prepared as a formal submission to the European Commission in response to its invitation for consultation on the review of the auctioning time profile of the EU ETS. This report draws on discussions that took place among the members of the CEPS Carbon Market Forum (CMF).

The CMF provides a neutral space where policy-makers and regulators are able to meet carbon market participants and other stakeholders to discuss carbon market regulation and general policy issues. The contents of this report reflect the general tone and direction of discussions on specific topics within the CMF, but its findings do not necessarily represent a full common position agreed by all the participants in the CMF, nor do they necessarily represent the views of the institutions to which the participants belong.

Andrei Marcu is Senior Advisor and Head of the CEPS Carbon Market Forum. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

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## Executive Summary

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The EU ETS (Emissions Trading System) is a pure regulatory construct and one that has functioned well as a market. An ETS should be the most cost-effective system to promote reductions in greenhouse gases and act as the cornerstone in EU's climate policy. Currently, some have the perception that the EU ETS has not delivered on some of its implicit objectives, including to serve as an instrument to encourage investments to meet long-term targets for GHGs in 2050.

A supply imbalance has been observed in the EU ETS, possibly temporary, which has led to some volatility in the market. As a result, a number of issues, real or perceived, need to be addressed:

- a) A significant oversupply in the market that may linger beyond 2020
- b) A large supply coming in 2012-13
- c) An inflexible ETS on the supply side
- d) The need to provide for longer-term structural changes that will affect the EU ETS, including other policies and measures that may be needed to accompany the ETS in some areas.

In providing answers, we need to make sure that we know which market failure, or potential market failure, we aim to address.

Backloading can only be introduced as a measure to address a market imbalance and ensure good market functioning. It should not be a measure to target a price outcome.

If implemented on its own, backloading will likely lead to the need for further one-off interventions, which should be avoided. It should be part of a set of measures that will include, as a next step, an examination of long-term structural measures that are needed to address points c & d above.

If backloading is to be an effective tool, it should have a number of characteristics:

- It should be **significant and forceful** to ensure a strong political and economic signal.
- Communication must be **clear and unambiguous**.
- **A significant time lag** between when the set aside takes place and when the volumes may be returned to the market.
- The volume of backloading should be larger in 2013.

# **Backloading: A necessary, but not sufficient first step**

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#### **Background**

On 25 July 2012, the European Commission issued an invitation for Public Consultation entitled “Consultation on review of the auctioning time profile for the EU Emissions Trading Scheme” in order to collect views from stakeholders and experts in the field of the EU carbon market on a draft for a future amendment of the Commission Regulation (EU) No 1031/2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances.

In this submission, the CEPS Carbon Market Forum addresses the questions below and offers its views on the Commission’s proposed amendments:

- Is back loading a good idea?
- Is there a need for following up the back loading with structural measures?
- What should the number be? If this cannot be addressed, what are the considerations for deciding upon that number?
- What price expectations are linked to the number? On what basis are they construed?

#### **1. The GHG Market – Facts and Views**

The EU ETS has been conceived as a pure regulatory market whose stated objective is to “promote reductions of greenhouse emissions in a cost-effective and economically efficient manner”. It was intended to become the cornerstone of the EU climate change policy and help reach targets under the Kyoto Protocol as well as EU climate change policies in general.

While the EU ETS was, as a cap-and-trade system, modelled on the CO<sub>2</sub> programme in the United States, it must be emphasised that beyond the similarity in their environmental dimensions, they are very different due to size/scale, economic/competitive impact, global reach and technology implications.

For some, the unstated objectives of the EU ETS were to drive not only operational change, but especially a technological revolution and also steer capital towards cleaner sources of energy, and assist with energy efficiency, and the development and deployment of renewables.

For others, GHG markets are a technologically neutral instrument of price discovery, helping to minimise the overall societal costs of compliance with GHG obligations. In such a view, if the price of carbon becomes zero in a particular trading period, it is not a concern, as it would signal that the problem is solved, and there is no demand for the product (allowances).

However, it must be emphasised that the problem referred to addresses the reduction of GHG emissions from anthropogenic sources by 90% in 2050, and not only an in-period objective, while we still have substantive long-term, un-met objectives. Only by meeting both the short-term and long-term objectives can economic efficacy be achieved. This requires a visibility of the environmental objective post-2020.

The GHG market has certain unique features, including:

- The traded product can be seen as having the characteristics of both a commodity and a financial instrument and

- While its demand varies with a number of factors, supply is inelastic and is based on a number of factors, including a forecast of economic activity, well in advance in some cases.

The EU ETS has gotten off the ground rapidly and has become the flagship of the EU climate change programme, and the hub and main demand for international credits. Its functioning has offered many lessons that have been adopted by emerging and developing ETS around the world, such as Australia, California, China, Korea, etc.

The EU ETS itself has applied many of the lessons learned, as witnessed by the increase in auctioning, allocation at the EU level, the move to one Community Registry, the change in security provisions, etc.

The market created by the EU ETS has functioned well, as measured against some of the criteria that reflect good market functioning, including: a credible level of periodic scarcity in the market; the presence of liquidity in the market, although many participants; a tight spread between bid and ask prices; the ability to enter and exit the market at all times; adequate market transparency and information; and the fact that the market is not driven by market power.

The EU ETS and carbon are deeply connected to the energy markets. At its inception, it was felt that carbon, as a commodity, would lead to and trigger arbitrage between different sources of energy. At present, however, carbon seems to be following the lead of the energy markets. Having energy policies that are established at the national level and a climate change policy that is set at the EU level creates tension as the two sets of policies are closely linked.

Concerns have been voiced about the price of carbon and the level of volatility. Volatility is closely linked to the level of liquidity in the market, with high liquidity dampening volatility. Volatility is negative when it manifests itself through abrupt price fluctuations, in a non-transparent way. It is also important to point out that, compared to other energy commodities, carbon prices have not shown a high degree of volatility.

The current low price levels in the EU ETS, especially on the EUA side, have created fears of a decrease in liquidity, as many intermediaries may exit the market. While this is, and must be seen, as an individual choice for market players, the resulting decrease in liquidity would impact negatively what has been until now sound market functioning.

Due to a series of factors, including inaccurate emissions data and non-banking in Phase 2, the end of Phase 1 in 2007 saw the price of carbon plummet to zero.

Currently, there is a large and growing imbalance in the supply/demand equation, especially due to the financial and economic crisis. This imbalance may be temporary in nature, especially given the long-term objectives of EU climate change policy. In the Staff Working Document (SWD) accompanying its proposals released on July 25<sup>th</sup>, the European Commission expected an oversupply at the end of 2020 to be on the order of 1.4 billion tonnes, with more recent data suggesting higher numbers, such as 1.4 or even 2 billion tonnes.

The current imbalance in the market resulted from economic conditions that were totally outside the bandwidth of what the EU ETS was designed for -- economic conditions that have been unprecedented for the last 80 years. In addition, a larger than expected supply of renewables has also impacted the level of GHG emissions, and therefore demand, for allowances.

Moreover, a large inflow of new supply is expected in 2012-13, due to a number of factors:

- Early auctioning
- National NER (new entrants' reserve) that will likely be auctioned
- NER 300, 200 million in 2012, another 100 million in early 2013
- Some CERs (industrial gases) will come in large quantities as their usefulness comes to an end in April 2013

## 2. What are we trying to solve?

Given the situation identified above, there are a number of issues, real or perceived, that need to be considered:

- a) A significant oversupply in the market that may linger beyond 2020
- b) A large supply coming in 2012-13
- c) An inflexible ETS on the supply side, which may require future interventions and the need to introduce some measure of flexibility
- d) The need to provide for longer-term structural changes that will affect the EU ETS, including other policies and measures that may be needed to accompany the ETS in some areas.

In providing answers to these issues, we need to make sure that we know what market failure, or potential market failure, in the absence of an intervention by the regulator, we are addressing.

It must be emphasised that through backloading we cannot, and do not intend, to address the inconsistencies between various policies that affect climate change, including energy and climate change, or address post-2020 targets.

## 3. Backloading

Backloading must be seen, designed and put in a framework that will guarantee that it ensures good market functioning. It is a rebalancing measure, to allow the large incoming supply and existing oversupply in the market to be absorbed in an orderly fashion.

What is needed is for supply to enter the market during the 2013-20 period in a way that is not disruptive and does not produce abrupt price changes. In the absence of any intervention, we are certain to see continued abrupt price fluctuations now, to be followed by potential renewed volatility at the end of the third trading period.

It must be noted that the CER market has reached a price level where its good functioning can be called into question. However, the current market situation for EUAs is also not totally dissimilar from that at the end of Period 1, except that prices have not totally collapsed due to a number of factors listed below:

- The expectation of intervention by the Regulator with a package of both short-term and long-term structural measures
- The possibility of banking allowances from Phase 2 to Phase 3 and
- The connection to future phases beyond 2020.

Backloading is a measure that can and should be implemented on its own at this time, as it can be rapidly put in place and does not alter the decisions related to intra-period market supply.

The GHG market is driven by sentiment, and backloading at this time, especially if done forcefully, can impact the market by providing a demand signal that is more in line with what the demand/supply balance is expected to be in the long term.

There are a number of conditions that must be met if backloading is to have any chance of being effective in meeting the stated objectives:

- It should be **significant and forceful**. Different models will provide different outcomes for levels of backloading. This is about market fundamentals, market sentiment and political signals. Given the current situation, any backloading less than one **billion tonnes** will be seen as reflecting a lack of political commitment, which may become a self-fulfilling prophecy. At the same time, there needs to be awareness that the legitimate markets' need for hedging must be incorporated in an appropriate number.

- **Communication** on the number and the terms of backloading, as well as the other steps that will be undertaken as part of structural change programme, must be **clear and unambiguous**. Mixed signals from the European Commission in the run-up to the July 25<sup>th</sup> announcement have somewhat shaken market confidence in the cohesion of the regulator and politicians on the EU ETS.
- There must be a **significant time lag** between when the set-aside takes place and when the volumes may be returned to the market.
- There must be a **larger backloading volume in 2013**, given the current situation, with potentially decreasing amounts after that.
- There must be **clarity this is not a measure to remove the supply permanently**, since structural oversupply and lack of flexibility to adapt to changing conditions will be addressed in a comprehensive way through measures that will take longer to consider and agree, but for which there is political will.
- **Clarity on the issue of long-term measures** will alleviate any fears that this is an ad-hoc and capricious intervention in the market, to be repeated at the pleasure of the regulator, without clear political guidance and parameters, which every regulator intervening in the market must follow.

Resolution of the issues listed at the start of section 2 (points c and d) is likely to require much lengthier consideration and political negotiations, and also to result in delaying an action that is essential for good market functioning for the upcoming period.

Backloading is not a measure that should be considered in order to ensure a price target. Rather, it should be introduced to bring about good market functioning, with the objective of ensuring that the ETS remains a credible instrument for price discovery for GHG mitigation measures.

Backloading will not address all the issues raised. To be effective it must be part of a broad set of measures that also address potentially long-term structural issues.

For backloading to succeed, the scope of the long-term measures to be considered to address points c&d must be outlined in a clear and unambiguous manner, in any outcome of the current policy discussion. To do otherwise will again test the trust of stakeholders and market participants in the level of support that the instrument has at the regulatory and political levels.

Various models have provided different price outcomes for the scenarios outlined by the European Commission in the documents it released on July 25<sup>th</sup>. They vary, sometimes widely, depending on the model and the modeller. However, backloading, or any other measure that may be envisaged in the future, should not be based on a price target. That would deny the benefit that a market approach is supposed to bring.

What backloading should ensure, and the number selected should accomplish, is a credible level of scarcity that will allow for good market functioning. No visible scarcity within the time horizon when there is a price and EUA contract on the market, does not meet the test set in the Directive.

#### 4. Observations of the CEPS CMF on the Proposed Amendments

With a view to contributing to the Commission's Consultation process, the CEPS Carbon Market Forum offers the following observations on the proposed amendments:

- The accompanying proposal to amend the Auctioning Regulation is very specific to the numbers and timelines proposed, and in our view addresses the issue at hand in an appropriate manner.
- The proposed amendment to the EU ETS Directive reads *"The Commission shall, where appropriate, adapt the timetable for each period so as to ensure an orderly functioning of the market"*.

- We understand that the proposed amendment to the EU ETS Directive is meant to ensure clarity, avoid any potential legal challenges, as well as ensure that any future legal challenge will not be successful.
- We feel that it is broad in nature and gives a lot of latitude to the regulator, which in many ways is needed, and should be welcomed.
- However, such authority is not customarily given to a regulator, unless it is accompanied by clear guidelines and definitions.
- That kind of debate should take place within the context of ensuring long-term flexibility to ensure a proper functioning of the EU ETS, as well as take into account other important aspects, such as carbon leakage for trade-exposed industries.
- Consequently, we feel that at this time, an amendment to the Directive should also provide a reference to a review of the Directive that will address the supply/demand imbalances and promote economic efficiency. This will ensure that flexibility is inserted in a deliberate way, with all necessary and customary guidelines and definitions.



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