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Vattenfall's position on revising the EU ETS directive for Phase 4 in light of the Paris Agreement adopted at the COP21 summit

Vattenfall applauds the Paris Agreement reached at the COP21 summit in December 2015 as one of the most important milestones in international policy making aimed at addressing the risks of climate change. The new global UNFCCC agreement for the post-2020 period is a clear signal of the global community's determination to drastically reduce the global GHG emissions, which will require a profound transition of the world's energy systems over the next decades.

The Paris Agreement is a confirmation of the path which the EU pursues in its strategy for becoming a low-carbon economy by 2050. It is also a confirmation for Vattenfall as we are committed to making EU power generation CO2-neutral by 2050 at the latest. A stronger ETS is required to support us and the society efficiently through this large transition.

The ongoing revision of the EU ETS directive for Phase 4 (2021-2030) is a very important opportunity to address the problems which the EU ETS has today and to make the policy better equipped for delivering efficiently on the EU's and the global decarbonisation goals.

1. **Align the EU climate policy with the Paris Agreement**
   - A predictable and timely procedure is needed for updating the EU climate targets and the EU ETS in view of the Paris Agreement's 5-year review cycle.
   - The EU needs to raise its climate target above 40% domestic GHG reductions by 2030 in light of the Paris Agreement's aspirational 1.5 °C goal.
   - The linear reduction factor of the ETS cap for the period after 2020 should already now be set at a higher level of at least 2.6 %.
2. **Protect the ETS market balance from being further distorted**
   - Avoid further distortions of the ETS market balance resulting from a premature release of ETS allowances from the MSR and the Innovation Fund.
   - The capacity and functioning of the MSR should be strengthened and coupled with a permanent cancellation of ETS allowances.
   - Improve the policy coherence and adjust the ETS auction supply for the impact of overlapping policies.
3. **Expand the scope of the EU ETS to other countries**

1. Align the EU climate policy with the Paris Agreement

➢ **A predictable and timely procedure is needed for updating the EU's climate targets and the EU ETS in view of the Paris Agreement's 5-year review cycle**

The Paris Agreement prescribes that a global stock-take of the GHG emissions and the mitigation contributions shall be performed regularly, with a view to reviewing (increasing) the level of ambition every 5 years. Based on this globally agreed timeframe, the EU should also define a process for updating its contribution to the Paris Agreement's objectives and for making the associated necessary reviews of the ETS directive.

- **The EU needs to raise its climate target above 40% domestic GHG reductions by 2030 in light of the Paris Agreement**

Already in the Council conclusions on the EU's 2030 climate and energy policy framework adopted in October 2014, it was recognised that a 40% reduction by 2030 is at the lower end of what the EU is expected to contribute for reaching the 2 °C target. With the global objective now being set at a maximum 1.5 °C temperature increase, it is even clearer that the EU needs to step up its ambition, just like other partners of the Paris Agreement.

For investors and the private sector in general, it is important to get full clarity on the EU's climate ambition as soon as possible. Therefore, the required preparatory work must be initiated without delay. A new 2050 Roadmap should be developed on the basis of the 1.5 °C target and be informed by the IPCC's next assessment report as well as forthcoming COP decisions on the actual design of the Paris Agreement's new flexible mechanisms.

- **The linear reduction factor of the ETS cap for the period after 2020 should already now be set at a higher level of at least 2.6%.**

In July 2015, the European Commission tabled a legislative proposal to revise the EU ETS directive as a part of implementing the EU's 2030 framework and making the EU ETS prepared for Phase 4 which starts in 2021. One element in this proposal is to increase the annual Linear Reduction Factor (LRF) from 1.74 % to 2.2 % per year. This would align the EU ETS cap trajectory with the EU's climate target of 40 % GHG emission reductions by 2030 and the lower end of the EU's 2050 decarbonisation target. To reflect the upper end of the EU's 2050 target, a LRF of 2.6 % would be needed. Since the EU ETS directive is up for revision in 2016-2017, including an adjustment of the LRF to reflect the EU's contribution under the global 2 °C scenario, it would be a suitable moment to already at this stage anticipate the further revision of the LRF that will be necessary if the EU aims to make a deeper cut than 40 % by 2030, which the 1.5 °C ambition clearly requires.

2. Protect the ETS market balance from being further distorted

- **Avoid further distortions of the ETS market balance resulting from a premature release of ETS allowances from the MSR and the Innovation Fund**

Alongside the decision to introduce a Market Stability Reserve (MSR) in the EU ETS from 2019, the EU institutions also agreed to transfer the backloaded 900 million EUAs, as well as a significant amount of unallocated Phase 3 allowances, directly into the Reserve. But according to the European Commission's legislative proposal from July 2015, an amount of 250 million EUAs shall be taken *from* the MSR and be used to create the Phase 4 New Entrants Reserve (NER). In Vattenfall's view, a more appropriate solution would be to create the Phase 4 NER by using EUAs from the Phase 4 allowance cap, in the same way that the Phase 3 NER was created by using EUAs from the Phase 3 allowance cap. This will support the MSR in reducing the ETS market surplus as early as possible.

Vattenfall supports the decision to extend the NER300 programme beyond 2020 and to scale up its initial funding with another 400 million EUAs, as well as broadening the scope to industrial processes where large technology shifts are needed to decarbonise the EU's economy. But in this case no ETS allowances (50 million) should be taken from the MSR to mobilise the intended 400 million EUAs. It is also crucial that the monetisation of the Fund is not performed too early, as that could counteract the MSR's efforts to reduce the surplus in the ETS market and also generate less revenues to support low-CO2 projects.

- **The capacity and functioning of the MSR should be strengthened and coupled with a permanent cancellation of ETS allowances**

As outlined in Vattenfall's EU ETS position paper from 2013, it would have been better if the MSR had started to operate from 2017 instead of 2019. In addition to contributing to a more robust EUA price development over the long-term, it could also remove significant parts of the historical over-supply from the market in the near-term. It is therefore natural to examine how the MSR's functioning and capacity can be further improved, preferably even before the first scheduled review in 2022. Another way to improve its capacity is to increase the yearly extraction rate, which is now set at 12 % of the total amount of EUAs in circulation.

The clearest measure to effectively address the over-supply of EUAs which has built up in the ETS market since the 2^{nd} trading period is to make a permanent cancellation of a part of the surplus. Such a recalibration of the supply and demand balance would reintroduce scarcity in the horizon and restore an incentive for the CO2 reductions which are needed to reach the EU's long-term climate targets.

As a first step, the natural candidate for making a permanent set-aside of some of the over-supply in the ETS is the volume of 900 million EUAs which were already withheld from auctions in 2014-2016. Other possible solutions include defining rules which stipulate that parts of the surplus in the MSR should be cancelled in case the size of the MSR has become very large, or in case EUAs have been locked up in the MSR for a very long time.

- **Improve the policy coherence and adjust the ETS auction supply for the impact of overlapping policies**

Other EU or national policy interventions which overlap with the EU ETS can often reduce the CO2 emissions locally or regionally, but from an EU-wide perspective the main impact is a geographical displacement of the CO2 emissions and a further weakening of the international CO2 price signal. It is therefore important that the resulting surplus of EUAs is taken into account when determining the ETS allowance cap for the relevant period.

The impact of overlapping policies should be carefully assessed by the European Commission and followed by an ex-ante adjustment of the ETS allowances cap, or a direct transfer of an equivalent amount of EUAs into the MSR. Member states which decide to introduce overlapping policies that are directly targeting CO2 emissions in the ETS sectors can also abstain from auctioning a corresponding amount of allowances to the ETS market. If no adjustment is done, the measure will lead to more oversupply and a weaker incentive for other Member states and sectors within the EU ETS to reduce their CO2 emissions.

3. Expand the scope of the EU ETS to other countries

- **The efforts to link the EU ETS with other carbon markets in the world should be intensified**

The Paris Agreement encourages countries to engage in cooperative approaches for reaching their respective climate commitments. Article 6 provides for a voluntary transfer of GHG emission mitigation outcomes between countries, as well as a new global market mechanism for supporting mitigation and sustainable development. The possibility to transfer entitlements across jurisdictions is an important feature that facilitates the linking of carbon markets. Following the agreement in Paris, the EU should intensify the dialogue with other countries with the aim to directly link the European carbon market with similar schemes in the world which already exist or are about to emerge.