The EU Emissions Trading Scheme and decarbonisation

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Roland Magnusson

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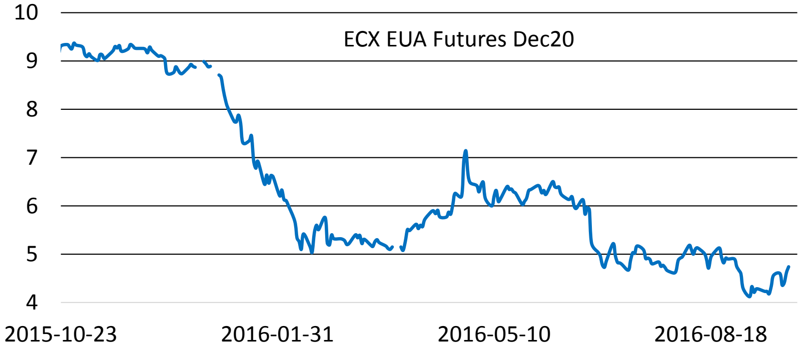
Key issues

Current EU allowance price is low



UK Carbon Price Floor (CPF)

- Since 2013, installations in UK have been required to pay a top-up tax if the allowance price is below a certain level, equal to €24.46 (£21.20) in 2016
- In 2016-2020, the top-up is capped at €20.77 (£18), which sets a the minimum CO2 cost for emitters

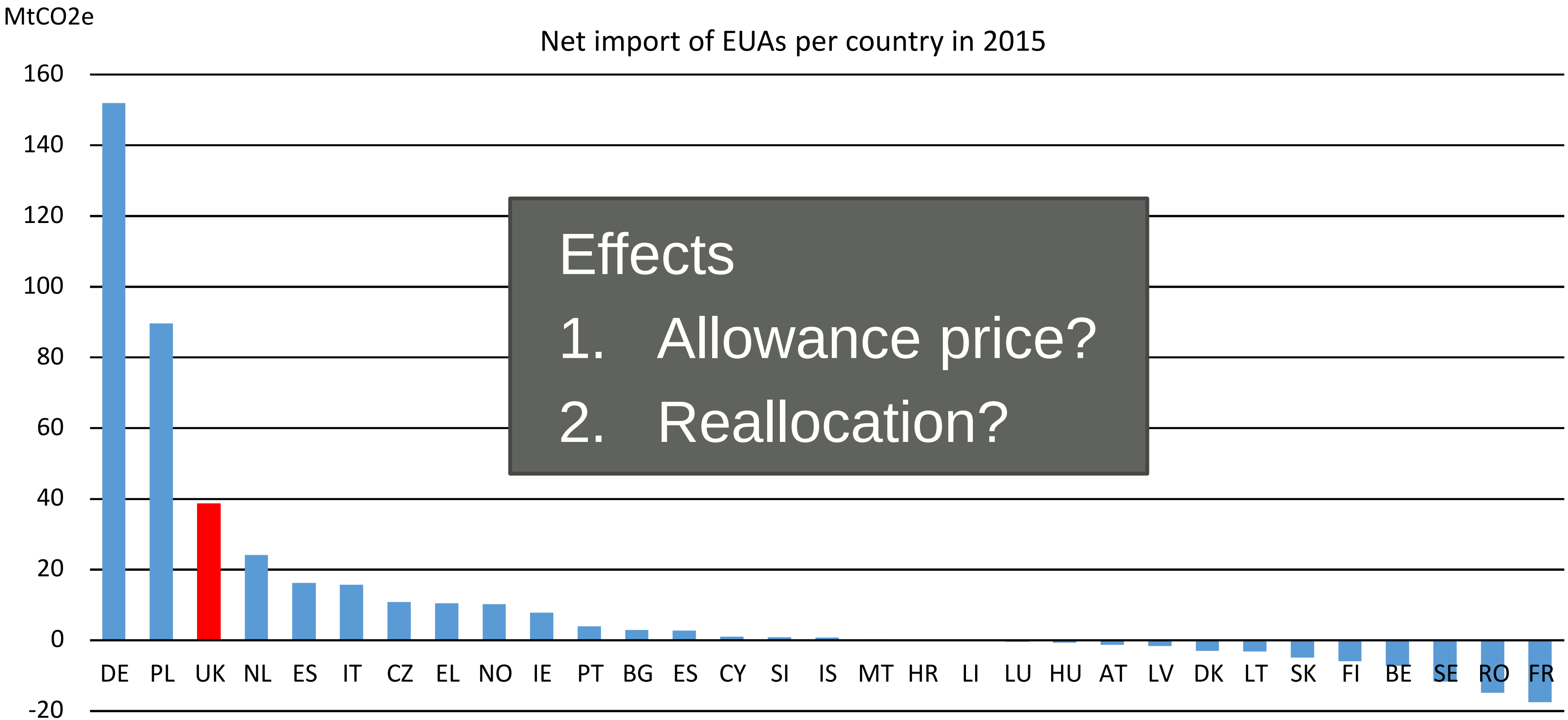
Measures to address the surplus

- A short-term measure: The Commission has backloaded a total of 900 million allowances from auctions in 2014-2016, which will be moved into the Market Stability Reserve
- A long-term measure: A Market Stability Reserve (MSR), scheduled to become operation in January 2019.

Role in the development of the EU ETS

- UK is the third largest emitter in the EU ETS (10%), after Germany (25)% and Poland (11%)
- UK, France and Germany, among others, proposed for the MSR to start in 2017.
- Poland has filed a lawsuit at the European Court of Justice, with the objective of postponing the start of the MSR to 2021.

UK is a net importer of allowances



Effects

1. Allowance price?
2. Reallocation?

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3 scenarios in which the UK continues to be part of the EU ETS

Norway Model

- The UK joins the EEA and the EFTA
- UK gains access to the single market
- UK is subject to EU standards and regulations
- Identical to how Norway, Iceland and Lichtenstein participate in the EU ETS

The Swiss Model

- The UK joins the EFTA and negotiates bilateral agreements on a sectoral basis
- The UK negotiates a bilateral agreement on linking a UK ETS to the EU ETS
- Identical to how the Swiss ETS links to the EU ETS

FTA Model

- The UK signs a free trade agreement with the EU, which stipulates the terms of linking a UK ETS with the EU ETS
- Is likely to be preceded by a period of no non-cooperation*

*Mid-term exit may be chaotic since parameters of the EU ETS are set at the start of each of each phase. The 3rd phase of the EU ETS ends on 31st December 2020.

Implications at different levels

The EU

- Loses a Member State committed to pricing carbon

The UK

- Is free to pursue a more ambitious climate policy

Electricity utilities in the UK

- Typically sell power forward up to X years in advance
- The uncertainties of 1) the time of a possible exit from the EU ETS 2) modalities of future participation creates problems for hedging the carbon price
- It is not obvious that EUAs can used for compliance after 2 years
- Hedging with the wrong instrument is a poor hedging strategy

Beijing office:
北京市朝阳区望京Soho, 邮编100102
Wangjing Soho, Chaoyang District, 100102 Beijing, China

Helsinki office:
Lapinlahdenkatu 3,
FI-00180 Helsinki, Finland

www.greenstream.net
Twitter@GreenStreamNet
GreenStream