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EU reforms to increase green investment

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Environment analysis: How will reforms to the EU emissions trading system (ETS) boost investment in low carbon technology? Peter Zaman, partner in the energy and natural resources team at Reed Smith, explores some of the main issues and considers the potential impact of the proposed reforms.

Original news

MEPs back emissions trading scheme market, LNB News 25/02/2015 154

A draft law to reform the EU ETS should be introduced early, by the end of 2018, according to Environment Committee MEPs who voted for the reforms. MEPs believed the proposed law, which would reduce the surplus of carbon credits available for trading in order to support the price, will send a strong signal that the European Parliament is serious about fighting climate change while also bearing in mind industry concerns.

What have been the main issues with the EU ETS to date?

The EU ETS seeks to incentivise companies to reduce their emissions and invest in low-carbon technology by imposing a cap on the total amount of greenhouse gases emitted. Within the cap, companies receive or buy emission allowances (EUA) which they can trade with one another in order to meet their emission requirements.

In recent years the EU ETS has faced an oversupply of EUAs which has caused the price of EUAs to fall to a point where they no longer provide an incentive for investment in low-carbon technology. This has been partially caused by Europe's natural movement towards a services-led economy and worsened by the impact of the global recession in recent years. Some estimates suggest that the current surplus of EUAs amounts to two billion tonnes--approximately equivalent to a year's requirement under the scheme. A low carbon price means that participants have little incentive to invest in cleaner, albeit more expensive, energy production technologies that result in reducing emissions. This defeats one of the two key purposes of the scheme that is to help the EU make a gradual transition to a low carbon economy. The other purpose is to set a price for a tonne of carbon, which the EU ETS has been doing.

How will the market stability reserve legislation (MSR) address the problems with the EU ETS and will it be successful?

MSR intends to render the auction supply of EUAs more flexible and to function as a pool of EUAs. According to the Commission's original proposal, if the amount of the cumulative surplus of EUAs is greater than 833 million, 12% of the total EUAs in circulation will be withdrawn into the MSR while deducting those allowances from future auction volumes. Alternatively, if the total number of surplus EUAs falls below 400 million, 100 million EUAs would be released from the MSR and added to future auction volumes. Furthermore, 100 million EUAs will be released from the MSR and added to the auction volume if the EUA price is three times higher than its average value of the previous two years. The result should be a market price for EUAs that remains within a range that hopefully encourages investment in low carbon technology.

Whether the MSR will really address the problems with the EU ETS will depend on factors currently being negotiated between the EU Parliament and the Council of Ministers as part of the co-decision process. These factors include:

- o the start date for the MSR--the original Commission proposal recommended 2021 while the recent EU Parliamentary Committee compromise proposed 2018/19. The earlier this date, the more quickly the EU ETS price may recover
- o 'backloaded allowances'--in 2019/20, 900 million auctionable EUAs are due to return to the auction quantity adding to the future length of the EU ETS. Although not in the original Commission proposal, the EU Parliamentary Committee has proposed that these 'backloaded' EUAs are moved into the MSR rather than returned to the EU ETS for auctioning. This proposal is designed to prevent further oversupply of EUAs which may enable the MSR to reduce the surplus sooner and smooth price increases over the next decade
- o the threshold limits--the threshold limits need be set at the correct level if the MSR is to be effective. If the upper threshold is set too high, a surplus will persist in the market, which will limit the effectiveness of the MSR. Furthermore, there is a risk that if the lower threshold is set too high, allowances could return to the market too soon which would prevent the carbon price from rising and incentivising low-carbon investments

Which key concerns and areas in need of reform does the joint statement identify?

Of the above factors, the governments' statement raises both the issue of 'backloaded allowances' and the prevention of EUAs returning to auction in 2020. The statement further sets out the governments' concern that the scheme's proposed start date in 2021 is too late and will cause firms to continue to postpone low carbon investments. Instead, the governments believe that the MSR should come into force in 2017. The statement also addresses 'carbon leakage'--the risk that a high carbon price could drive certain energy-intensive industries to relocate overseas. However, this is probably not a key feature of MSR but a secondary consideration designed to enable the MSR to secure Council approval.

Could there be any unintended consequences or has anything been left out?

The impact of the legislation depends on how the final draft addresses the issues discussed above. However, the draft legislation as a whole suggests that there will continue to be a permanent surplus of EUAs. While some surplus of allowances is necessary for the market to function effectively, too large a surplus could result in the EUAs failing to reach their price targets permanently. As a result, some commentators have argued that the lower threshold of 400 million should be reduced or that allowances should only be allowed to return to the market when both the price of EUAs rises and the surplus thresholds are met. Furthermore, there is no discretion built into the proposed mechanism. Therefore, if the MSR fails to operate as predicted, there will be no opportunity for the EU to interfere with the MSR until its first scheduled review--which the EU Parliamentary Committee has suggested should be three years after the MSR comes into operation.

The very nature of the EU co-decision process involves the dilution of the best solution with what is a politically acceptable solution. That solution must succeed in receiving the necessary qualified majority support from the Council and majority support from the European Parliament. As each EU country or parliamentary group looks towards its own interests, this process often creates a compromise position that reflects a 'lesser of two evils' outcome rather than one that is focused on achieving the best possible version of the MSR. Unintended outcomes are therefore often the result of such negotiating stances and should not come as a surprise.

What should lawyers advising in this area take note of?

Lawyers need to follow the policy changes closely in order to advise clients on potential positions that they may be taking today on investments with an investment horizon of over five years. Unlike other commodity markets, the carbon market is disproportionately impacted by policy decisions compared to other market fundamentals such as supply and demand.

These policies are not just EU policies but also global. For example, the EU's position and target for phase 4 of the EU ETS is likely to be consistent with its intended nationally determined contributions for the proposed new international agreement--which will be agreed in Paris in December 2015 and will replace the Kyoto Protocol from 2020.

What are the trends in this area and do you have any predictions for the future?

The EU has had the benefit of being the first mover but has also had to be the first to learn the sometimes hard lessons of setting up and operating a carbon market. Those setting up newer markets have had the benefit of learning from the EU ETS's challenges and the EU ETS remains therefore a case study for others to learn from. For example, price management tools have been designed as part of California's AB32 emissions trading scheme.

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Interviewed by Helen Redding.

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