Safeguarding the proper functioning of the EU Emissions Trading System (ETS)

To:
Anna Hubáčková, Minister of the Environment, Czech Republic
Frans Timmermans, Executive Vice President, European Green Deal, European Commission
Kadri Simson, Commissioner, Energy, European Commission
Pascal Canfin, Chair of the Environment, Public Health and Food Safety Committee, European Parliament
Peter Liese, Member of the European Parliament

Copy to:
Zbyněk Stanjura, Minister of Finance, Czech Republic
Mairead McGuinness, Commissioner for Financial Stability, Financial Services and Capital Markets Union, European Commission
Irene Tinagli, Chair of the Economic and Monetary Affairs Committee, European Parliament
Natasha Cazenave, Executive Director, European Securities and Markets Authority

15 September 2022

Dear Minister Hubáčková,
Dear Executive Vice President Timmermans,
Dear Commissioner Simson,
Dear MEP Canfin,
Dear MEP Liese,

The EU Emissions Trading System (EU ETS) is a cornerstone of the EU's policy to combat climate change. To reach its decarbonisation objectives, the EU needs a liquid and resilient carbon market that encourages power sector and industry to rapidly decarbonise. However, recent proposals by the European Parliament risk significantly undermining the efficient functioning of the EU ETS and putting at risk the EU's ability to meet its climate goals in a cost-efficient manner.

Members of the European Parliament have supported amendments to limit participation in the EU ETS to compliance entities and financial intermediaries purchasing allowances on their behalf, amid unsubstantiated claims that the rising energy prices are directly linked to a speculative behaviour by financial intermediaries.

This approach clearly fails to consider changes in the EU's climate policy and the increased economic activity post-COVID-19, against the backdrop of gas and power shortages in Europe since 2021.

Evidence from European Securities and Markets Authority (ESMA) in their Final Report on the European Union Carbon Market and by the European Central Bank's (ECB) analysis on The role of speculation during the recent increase in EU emissions allowance prices demonstrates that the recent spike in the carbon price is not driven by the activities of financial institutions but by changing market fundamentals.

According to the aforementioned reports, factors that have led to the acceleration of the price increase since early 2021 are:

- The announcement of the *"Fit for 55"* package of legislative proposals and the EU's increased ambition to reduce emissions by 55% by 2030.

- Reformed Phase 4 of the EU ETS, which entails decreasing the number of allowances available in the market.

- Exceptionally high gas prices, which encouraged electricity producers to switch from gas to more CO_2-intensive coal-fired power generation, thereby increasing the demand for carbon permits.

- Particularly cold weather at the beginning of 2021 causing energy demand to rise.

- The increased demand following the loosening of the main COVID-19 restrictions.

Safeguarding the diversity of participation in the EU ETS

The EU's carbon market has emerged as the backbone of the EU climate action and as a crucial driver of decarbonisation.

The proposed market restrictions would undermine the ability of many companies to manage their risks related to fluctuations in the price of emission allowances, regardless of whether these are compliance entities or other entities exposed to this price risk.

Compliance entities are naturally on the 'demand' side of the carbon market and use long-term contracts to manage the price risk of the emission allowances they have to purchase to fulfil their compliance obligation. For this, they need companies willing to conclude such contracts with them, thereby taking the 'supply' side of the transaction.

Financial institutions participate in the market by buying and selling allowances on a continuous basis, thus acting as 'client facilitators' and 'market makers'. This is particularly important in the carbon market, where there is only one supplier of emission allowances (governments). Financial institutions provide an integral service to compliance entities, supporting market liquidity and price visibility, and allowing operators to hedge against future price fluctuations and better allocate their working capital by delaying payments for future usage.

Impact on European businesses

Restricting financial institutions' market access would not address the recent upward price trajectory but would instead reduce liquidity in both the long-term markets and in the auctions, resulting in increased price volatility and potentially in auctions failing to clear. In the absence of successful auctions, the regular supply of allowances would be disrupted, leaving EU governments without the expected auction revenues. During the first 7 months of 2022 alone, the auctions raised 24 billion EUR for Member States.

The 'plumbing' of the market would also be hindered if Central Counterparties and exchanges were banned from holding accounts in the Union Registry. As a consequence, they would no longer be able to clear and settle trades, with implications for the overall market architecture.

Furthermore, the proposed market restrictions would increase the capital needs for corporates. They would have reduced access to futures/OTC forwards positions from financial firms, who often purchase allowances in the short term spot markets or auctions, a common practice which provides implicit financing at a time when investments are required to finance the transition. Smaller entities in particular may lack the human and financial resources to actively participate in Exchange Traded Markets and depend on these services.

The diverse ecosystem of participants ensures that the EU's carbon market is resilient, less costly to access, and better equipped to provide hedging and risk-management solutions to companies. It is seen as a global benchmark for carbon trading and a success that other regions are seeking to follow.

Interventions such as restricting market access to compliance entities would impair the efficient functioning of the EU ETS and risk jeopardising Europe's decarbonisation efforts. We therefore urge the co-legislators not to impose such harmful restrictions.

We would be delighted to discuss our views on the issue with you in more detail.

Sincerely,

Adam Farkas
Chief Executive Officer, AFME

Cillian O'Donoghue
Director - Policy, Eurelectric

Wim Mijs
Chief Executive Officer, EBF

Christian Baer
Secretary General, Europex

Walt Lukken
President and Chief Executive Officer, FIA

Dirk Forrister
President and Chief Executive Officer, IETA

Mark Copley
Chief Executive Officer, EFET

Scott O'Malia
Chief Executive Officer, ISDA