

Institutional Investors Group on Climate Change

Response to public consultation on Green Paper on a 2030 framework for climate and energy policies

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Introduction

IIGCC has issued a public Statement in response to the Green Paper on Climate and Energy. (http://www.iigcc.org/_data/assets/pdf_file/0018/15453/IIGCC-Investment-grade-climate-policy-the-next-phase-for-Europe.pdf). This sets out on the topics raised by the Green Paper as well as those discussed in the earlier consultation on reforming the ETS.

The following provides answers to the questions asked at the end of the Green Paper. However, it is not intended to be a substitute for our Statement, which also addresses a number of issues not covered by the questions below.

4.1 General

Which lessons from the 2020 framework and the present state of the EU energy system are most important when designing policies for 2030?

The 20-20-20 framework has been powerful in driving deployment of renewables to date. But there are growing concerns about the cost, fragmentation and instability of this approach. The current emphasis on member state subsidies is not well aligned with Europe's single energy market vision. We would prefer much greater weight to be placed on a reliable, economically meaningful, pan-European carbon price signal. The EU Emission Trading Scheme (ETS) has the potential to provide this signal, but it will require modification (see below).

We have become very concerned about the growing number of changes member states are making to their subsidy regimes, with retroactive impacts on our investments. Many IIGCC members face the risk of serious investment impairment as a result. This is destroying confidence in investment in low carbon assets. We ask the EU should take stronger steps to discourage retroactive changes to subsidy regimes, including the introduction of new taxes which have the equivalent impact. We call on the Commission to consider what action it could take under the Renewable Energy Directive, or otherwise, to prevent any further such changes.

4.2 Targets

Which targets for 2030 would be most effective in driving the objectives of climate and energy policy? At what level should they apply (EU, Member States, or sectoral), and to what extent should they be legally binding?

The most important target is an overall carbon target. We support a target for 2030 reducing emissions on 1990 by 40%. This should be achieved primarily via the ETS (and so mandatory), but also via other sectoral measures.

Any national targets should be designed to avoid driving fragmentation of energy markets and be aligned with the ETS.

Have there been inconsistencies in the current 2020 targets and if so how can the coherence of potential 2030 targets be better ensured?

It is important to ensure that if future renewables or energy efficiency targets are introduced, ETS allowance allocation is adjusted to take account of their expected and actual outcomes, to avoid the accumulation of a structural surplus.

How can targets reflect better the economic viability and the changing degree of maturity of technologies in the 2030 framework?

An overall carbon target delivered primarily via the ETS is the most cost-effective approach, and is flexible in the face of unexpected technology change. This is why we think it should take a more central role.

4.3. Instruments

Are changes necessary to other policy instruments and how they interact with one another, including between the EU and national levels?

For the various reasons we have discussed in our Statement, we believe the ETS should be the central mechanism driving the low carbon transition. However, in order to provide investors with the price signal we need, the ETS must be modified by removing the structural surplus of carbon allowances, and by introducing a mechanism to adjust the supply of allowances in the event of unexpected supply and demand outcomes.

We are concerned that we are unlikely to have certainty about the post-2020 framework until 2015 or beyond. This is 'yesterday' from an infrastructure investment perspective. Energy infrastructure projects require several years to plan and operate for decades. The shorter the time horizon over which there is policy certainty, the stronger the incentive for investors to defer investment. The longer we have to wait before the post-2020 policy framework is finalised, the stronger the economic incentive to defer investment decisions, which impacts on short-term economic growth and long-term risks for energy security.

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Investors need a longer time horizon over which future policy is predictable. 15 years would be preferable. We would welcome even longer-term targets, particularly for 2040, which would further clarify the roadmap towards the 2050 objectives. The current short time horizon is not a one-off problem. If the EU continues with its episodic approach to target revision it will happen again. As we move into the second half of the next target period, the time horizon will again become too short, and investors will start to defer their investments. If the Commission is not able to set a target for 2040, we urge the Commission to review long-term targets more regularly, ensuring investors always have a target 15 years ahead, rather than leaving it till the mid-2020s to set the post 2030 target.

We believe that immature low carbon technologies (e.g. offshore wind) may offer significant environmental and economic benefits over the medium term, and the EU should continue to support their development as well as supporting the construction of Carbon Capture and Storage (CCS) demonstration projects to assess their potential viability.

It is important that any new instruments introduced to support renewables, CCS, and energy efficiency are designed to work with the ETS, or if not, that the allocation of allowances is adjusted to take account of their effects.

How should specific measures at the EU and national level best be defined to optimise cost-efficiency of meeting climate and energy objectives?

As indicated, we think the emphasis should be placed on a properly functioning pan-European Emissions Trading Scheme.

How can fragmentation of the internal energy market best be avoided particularly in relation to the need to encourage and mobilise investment?

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4.4. Competitiveness and security of supply

What are the specific drivers in observed trends in energy costs and to what extent can the EU influence them?

Many factors are combining to increase energy costs, including:

- Higher fossil fuel prices, especially for natural gas.
- Carbon Pricing. Until very recently, EU ETS carbon pricing was a factor in energy costs, as that cost has declined and has made coal more competitive (economically, not environmentally) the price increases associated with carbon have lessened, but they are still there.
- Electricity market structure. The EU electric and gas markets remain dominated by a few oligopolistic utilities and there is insufficient competition.
- Renewable Energy. It is well acknowledged that renewable energy is in a transition phase to competitiveness, but while it is the support for it increases end user energy costs;

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- Need for new energy infrastructure. In many places in the EU the energy infrastructure, especially transmission and distribution networks, but in many places like the UK generation assets, are at end of life and need to be replaced. These old, fully amortized assets whose return was based on marginal operating costs will be replaced with new assets, in which both operating and capital costs must be recovered, increasing prices.
- Increasing costs of capital. The European financial crisis, overleveraged EU utilities and concerns about regulatory risk are increasing the cost of capital for Europe relative to many other parts of the world.

It will be hard for the EU to influence global fossil fuel prices, but it can assist in lower costs in the following areas:

- By moving rapidly to a genuine single market in energy, as a result of economies of scale and greater competition, as well as the geographic benefits for renewables arising from continental scale.
- By adopting the most economically efficient instruments to drive low carbon, in other words an effective ETS.
- By creating a more stable, reliable, coherent and long-term policy framework for energy and climate; including eliminating or even reversing retroactive policy changes.
- By encouraging energy market reform, including the structure of gas markets and long-term gas contracts.
- By reducing the increased capital costs in infrastructure arising out of Basel 3 and Solvency 2, which penalize long-term investment.

How should uncertainty about efforts and the level of commitments that other developed countries and economically important developing nations will make in the on-going international negotiations be taken into account?

The reform to the ETS should allow for adjustments to be made to reflect additional ambition arising from international agreements.

How to increase regulatory certainty for business while building in flexibility to adapt to changing circumstances (e.g. progress in international climate negotiations and changes in energy markets)?

We support the redesign of the ETS to introduce a mechanism that adjusts the supply of allowances to reflect unexpected economic or technological changes. We believe that such a mechanism will result in a more predictable carbon price, increasing certainty for investors. It is important that such a mechanism is based on clear principles and a transparent process.

We are very concerned that the EU has not been good at considering the unintended consequences of regulations for investors in low-carbon energy. Proposals for Solvency 2 and the Unbundling of TSOs, have both had a substantial chilling effect on investment. While progress has been made in the right direction on both of these issues, it has been extremely slow, and remains inconclusive. We urge the Commission to develop the capacity to respond more rapidly on these topics.

As already indicated, we are deeply concerned about the retroactive changes that a growing number of member states have made to their support schemes for renewables. These have put IIGCC member investments at risk, and greatly undermine our confidence in placing future investments in the countries concerned.

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How can the EU increase the innovation capacity of manufacturing industry? Is there a role for the revenues from the auctioning of allowances?

Recycling auction revenues into research, development and deployment of industrial energy efficiency and alternative low-energy business models would be an appropriate and potentially valuable dual contribution to competitiveness and decarbonisation.

How can the EU best improve security of energy supply internally by ensuring the full and effective functioning of the internal energy market (e.g. through the development of necessary interconnections), and externally by diversifying energy supply routes?

We strongly support the EU vision for a single market in energy. We do not have specific views on the steps necessary to create it. But we do wish to encourage climate policies, like the ETS, that are aligned with the single-market; rather than those that drive fragmentation.

4.5. Capacity and distributional aspects

How should the new framework ensure an equitable distribution of effort among Member States? What concrete steps can be taken to reflect their different abilities to implement climate and energy measures?

One attraction of a properly functioning ETS is that it will generate a significant flow of auction revenues that can be used to support the efforts of member states facing the most difficult transition challenges. ETS revenues will disproportionately arise from these countries. This makes it reasonable to justify revenue recycling mechanisms to fund accelerated investment in renewables, storage, CCS and other technologies in these countries.

Are new financing instruments or arrangements required to support the new 2030 framework?

Yes. The substantial capital required to finance Europe's low carbon ambition requires a healthy investor ecosystem - one that provides finance across the range of project stages and risk profiles (development, construction and operation), over different durations, meeting the needs of large and small institutional investors alike. We urge the Commission to consider gaps in this ecosystem and foster the development of a stronger finance ecosystem.

The historic unlisted infrastructure fund model (limited life and using leveraged structures) is attractive to many investors, but not all. The traditional model will continue to play a role, especially during the risky development and construction stages which are still not fully understood by many investors.

However, for an increasing number of pension funds and insurance companies, there is an appetite for direct investments and for lower-gear, longer dated structures, some of which are coming to market. We need to encourage the development of all of these. In the UK, the new PIP potentially offers a useful model.

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Another barrier to large-scale institutional investment into the low carbon sector is the lack of public instruments for investment. Most pension fund and insurance capital is allocated to liquid, listed investments, and always will be. Most infrastructure investment to date has been through unlisted private equity and debt vehicles, where investors are required to commit to investments for 7-10+ years with little control over when investments are realised. Although some of our members can make illiquid investments, many institutional investors are required to invest in listed debt and equity.

A much deeper pool of capital could be accessed if listed vehicles were available on a more widespread basis. In the United States, discussion is underway about modifying regulations to allow Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs) to invest in some forms of renewable energy, allowing the liquidity and tax advantages of these structures to be utilised for low carbon investment. Both investment structures have been tried and tested in the US for conventional hydrocarbon-based energy, and have played an important role in financing the booming energy sector.

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