



2 October 2012

EU Emissions: Still Waiting For Political Clarity

Commodities Special

- The EU emissions market is still waiting for clarity on the issue of the back-end loading of allowances from the pool of Phase-3 EUAs to be auctioned over 2013-20, and significant developments on this question could be forthcoming in Q4.
- As explained in previous notes (in particular *Changes to the Phase-3 auctioning profile: a note on timing* from our 3 August 2012 Commodities Weekly, and *Longer term reform of the EU-ETS: a straw in the wind?* from our 7 September 2012 Commodities Weekly), there are two key political processes that need to be carried out to enable the Commission to proceed legally with the back-end loading of allowances: (i) an amendment to the EU-ETS Directive itself; and (ii) an amendment to the EU Regulation on Auctioning. And in addition to these legal processes being completed, the all-important question regarding the volume of allowances to be back-end loaded is yet to be stipulated.
- The political procedures are complicated by the voting processes. Initially, the Commission intended to proceed purely on the basis of an amendment to the Auctioning Regulation, but in July it announced that it would seek a proposed amendment to the EU-ETS Directive as well. This was done, in our view, in order to pre-empt any future legal challenge of a decision to back-end load allowances on the basis of an amendment made to the Auctioning Regulation only.
- The complication arises from the fact that even the single-sentence change to the Directive now being requested by the Commission will require votes from both the Council of Ministers (hereafter "The Council") and the European Parliament, under qualified majority voting (QMV) and simple majority votes respectively, while separately but concurrently the CCC will consider the Commission's proposed amendment to the Auctioning Regulation.
- We assume that the vote in the CCC on the Auctioning Regulation will only happen *after* the Parliament and the Council have voted on the proposed amendment to the Directive, and with formal discussions in Parliament yet to start and Council progressing slowly at present we struggle to see votes on the Directive at the next Parliament meeting on 22-26 October and at the next Council meeting on 25 October.
- This means there is a risk that (i) Parliament's vote will be delayed to the 19-22 November parliamentary session (or later), and (ii) that Council will not get to vote on the proposed amendment to the Directive until its following meeting, on 19 December (or later). In turn, this would risk delaying the vote in the CCC on the proposed amendment to the Auctioning Regulation until December or later.
- In short, under a best-case scenario a change to the Directive could still be voted on by the end of October, thereby allowing a vote in the CCC on the back-end loading proposal in mid-November.
- **However, we think it more reasonable to assume that Parliament and the Council will not have voted on the amendment to the Directive until late November and late December respectively (rather than late October), thus likely leaving a vote in the CCC on the amendment to the Auctioning Regulation for January 2013**
- One final caveat: if in the Commission's view a change of the Directive were only required for the final endorsement of the CCC vote on back-end loading rather than ahead of the CCC vote itself, a vote in the CCC before Parliament and Council vote on the Directive would still be possible. Under this eventuality, then, it would be possible to have clarity on the whole back-end loading process by the end of the year, as per the Commission's wish. However, it remains to be seen whether the Commission would accept such a sequence.
- In terms of the volume of allowances to be back-end loaded, the Commission has given three possible orders of magnitude: (i) 400m; (ii) 900m; and (iii) 1,200m. In our view, a number around 400m would be a disappointment to the market and would risk seeing prices trade lower than current levels, while a number close to 900m or 1,200m should in our view be enough to push prices back towards €15/t over the 12-18 months following such a decision.

Back-end loading: key decisions looming in Q4

Since July, the Commission's position has been that agreement on an amendment to the EU-ETS Directive clarifying the Commission's power to change the profile of Phase-3 auctions should be a pre-requisite to the back-end loading of allowances.

We understand the Commission's intention is to have an agreement on the amendment to the Directive (which would clarify the Commission's power to propose a change to the Phase-3 auction profiling) ahead of a vote in the CCC amending the Auctioning Regulation (which would allow for the actual back-end loading of allowances itself).

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To amend the Directive, the Commission has proposed what in the technical parlance of the EU is known as a "Decision", as decisions are directly applicable with no need for transposition. Such a process could take less than six months, and is greatly facilitated by bi-lateral discussions between institutions and dialogue discussions (that said, we are not sure this optimistic timing will apply in this case).

Figure 1 below summarizes the timeframe for the ongoing processes to amend the Directive and the Auctioning Regulation as we understand them at this point in time.

Change of the Directive – the Council process

The first important look at the proposed amendment to the Directive came from the Council. Council-headed Working-Parties meetings with Member-State experts took place on 7 and 17 September. The meetings ended with no clear position on the Commission's proposal as many Member States had reservations. One point of contention was the interpretation of the proposed wording "*where appropriate*" in Article 1 where some Member States see a need to restrict the power of the Commission:

"The Commission shall, where appropriate, adapt the timetable for each period so as to ensure an orderly functioning of the market." (Article 1 of the proposed Decision to amend the EU-ETS Directive).

Further discussions are therefore needed to reach an agreement within the Council and additional meetings would have to be scheduled so as to have a vote at the next meeting of the Environment Council on 25 October.

Assuming such discussions were scheduled and were sufficiently productive, it might still be possible for the Council to reach an agreed position on 25 October, but on balance at this point in time we think it is more realistic to assume a vote being held at the following meeting of the Council, which is due to be held on 19 December.

Change of the Directive – the Parliament process

The administrative parliamentary work necessary with regard to amending the Directive started with the Committee referral announced on 11 September and with the rapporteurs of the relevant Committees appointed in the wake of that announcement.

The Committee responsible for the proposed change to the Directive is the Environment, Public Health and Food Safety (ENVI) Committee.

The ENVI Chair is Mr Groote, a socialist from the Progressive Alliance of Socialists and Democrats, is the rapporteurs. The Industry, Research and Energy (ITRE) Committee is an opinion Committee, and its rapporteur is the ITRE Chair, Mrs Sartori, from the centre-right European People's Party (EPP).

However, these are only administrative steps and concrete discussions and meetings are still needed to scrutinize the proposal. This might be difficult to arrange before the next parliamentary session in only three weeks' time. We understand a first hearing on the proposed amendment could take place in October within the ENVI Committee, but further discussions will be needed to assist MEPs in arriving at a view on this proposal.

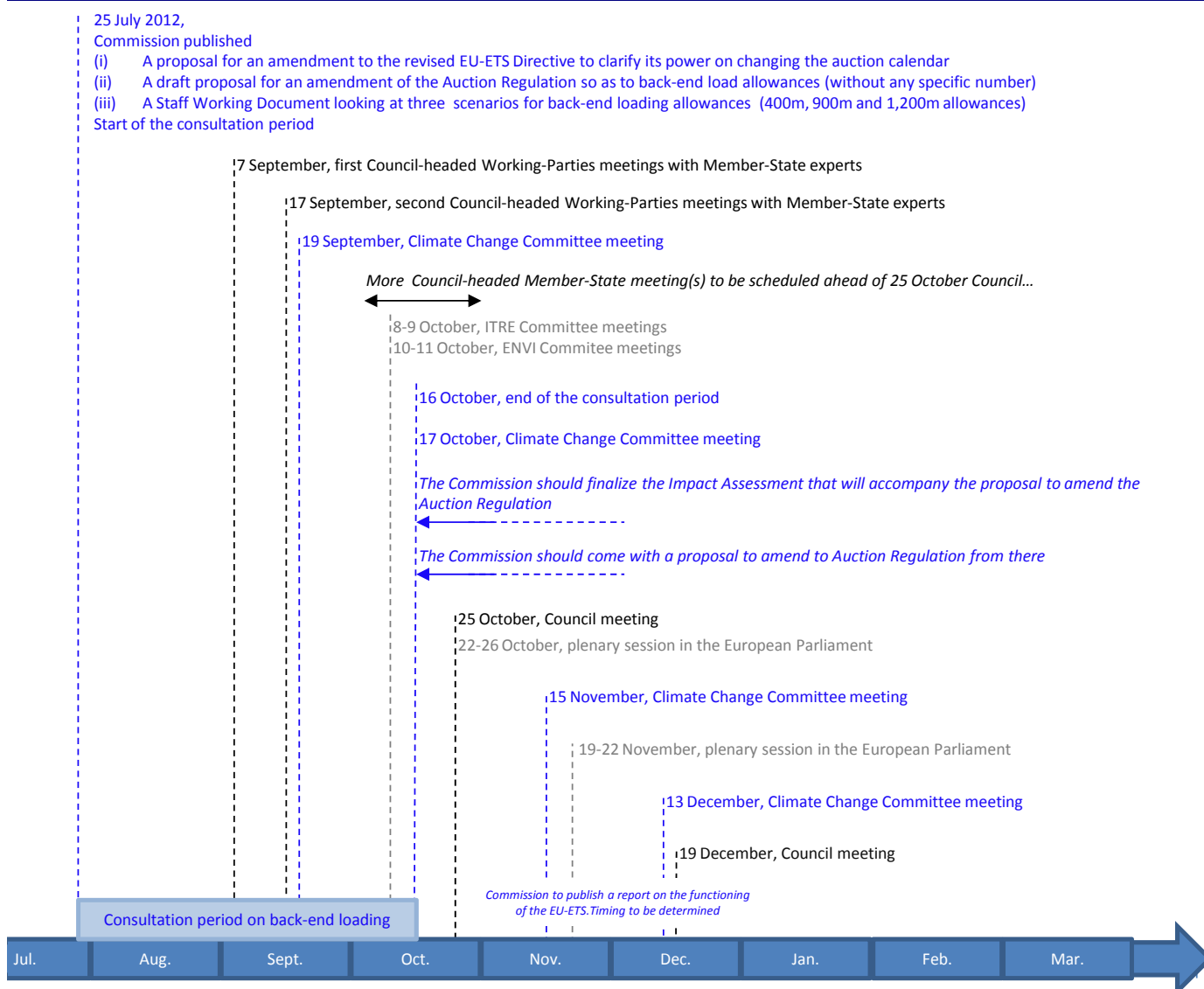
In order to speed up the decision-making process, the Committee Chair may propose to support the Decision clarifying the Directive without amendments. If less than one tenth of the Committee members object, the ENVI Committee Chair could submit a report supporting the proposal to Parliament. In principle, a decision in plenary session of the European Parliament could be taken from there. However, we are not certain at this stage that his strategy will be the one adopted by the Chair of the ENVI Committee.

The next standard ITRE and ENVI Committee meetings are scheduled for 8-9 October and 10-11 October respectively, but we have no information on the agendas of these meetings at this stage. If these committees were to discuss the proposal to amend the Directive and to agree on a position on these dates, the Parliament could take a position at the 22-26 October parliamentary session. Otherwise the next plenary session would be on 19-22 November.

Conclusion on the timing of amending the Directive

While on a best-case scenario it remains possible that both the Parliament and the Council might reach their respectively agreed positions by the end of October, we do not think this is the most likely outcome in either case.

As explained above, to us it seems more likely (although still not certain) that the Council would be able to reach an agreed position in time for a vote at its meeting of 19 December. Similarly, for the Parliament, we think it is reasonable to assume – although, again, not a foregone conclusion – that an agreed position amongst the relevant committees could be reached in time for a vote at the plenary session of 19-22 November.

Figure 1: Timeline of the decision-making process on amendments to the Directive and to the Auctioning Regulation

Source: Deutsche Bank.

The proposal to amend the Auction Regulation in CCC

Although the Commission sees a vote on the change to the EU-ETS Directive as a pre-requisite to vote on amending the Auctioning Regulation in CCC, it is certainly possible for drafting work and discussions on a proposal to back-end load allowances to be undertaken before an amendment to the Directive has been agreed and voted.

And it is to this end that the Commission released a draft proposal to amend the Auctioning Regulation already in July of this year. In this way the Commission wanted to gather stakeholders' opinions, such that at the same time, and in the same vein, it launched a consultation process on the profile of Phase-3 EUA auctioning. This process will run until 16 October.

The final version of the proposal to amend the Auctioning Regulation with a view to allowing the back-end loading of Phase-3 EUAs should be published at the same time as or after the publication of an Impact Assessment of back-end loading. In this respect, the Commission is expected to finalize an impact assessment on back-end loading after the end of the consultation process.

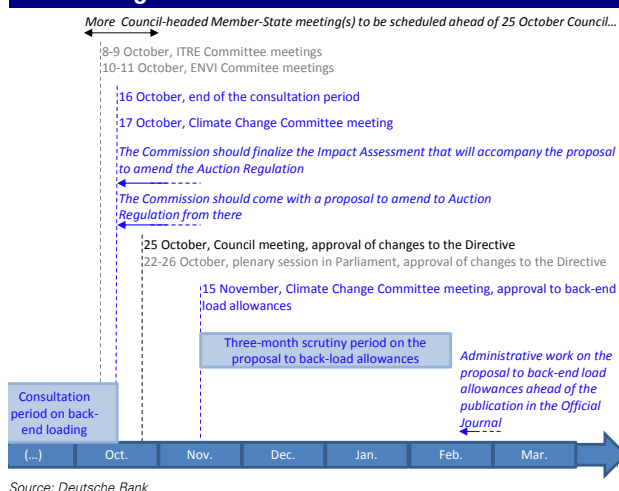
On the one hand, the Commission indicated the Impact Assessment will draw on the Staff Working Document already published in July, which suggests to us that it is already work in advanced progress. On the other hand, the Impact Assessment will draw on stakeholders' feedback under the consultation process, which can be submitted up to 16 October.

As a result, we do not believe the final proposal to amend the Auctioning Regulation could be discussed at the next Climate Change Committee meeting, coming as this does on 17 October (i.e. only one day after the closing of the consultation process).

Moreover, the 17 October meeting off the CCC takes place before the first foreseeable date by which the European Parliament and the Council could have come to an agreement on the clarification to the Directive, thereby impeding in any case a vote on the back-end loading of allowances in CCC (assuming the Commission's intention is still to wait for clarity on the amendment to the Directive before voting on the Auctioning Regulation).

In principle, the final proposal to back-end load allowances should be disclosed to CCC members 14 days ahead of the meeting in which it is to be discussed, but exemptions to shorten the limit are very frequent. As such, we believe that any final proposal released up to mid-November could be discussed and potentially voted on in the 15 November CCC meeting. In our view, therefore, this is the first foreseeable date for a vote in the CCC (Figure 2).

Figure 2: Best-case scenario for a decision on back-end loading allowances



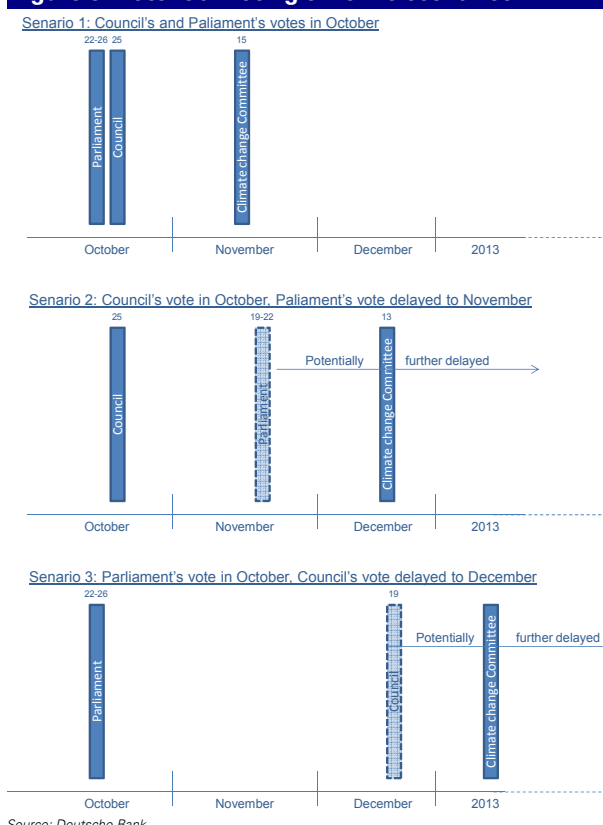
However if the Commission were to stick to its self-imposed ordering of events (under which, as explained above, a political consensus on an amendment to the Directive would be required before a vote on the back-end loading proposal can be held), then a vote in the CCC on 15 November – and indeed even at the CCC's following meeting on 13 December – looks unlikely to us. This is because, as explained above, we do not expect agreement on the Directive in Parliament before 19-22 November at the earliest, and in Council before 19 December at the earliest.

Note that if the Council had in fact managed to vote on 26 October but Parliament had not yet supported the change of the Directive by that time, the next potential date for a vote in Climate Change Committee would be on 13 December given that the Parliamentary session of 19-22 November would come too late for giving the green light to allow for a vote on the proposal to back-end loading allowances at the 15 November CCC meeting (see Figure 3 scenario 2).

In our opinion, however, even the 13 December CCC meeting will likely be too early for a vote on a change to the Auctioning Regulation since in our view the Council is unlikely to vote on the Directive before its meeting on 19 December.

This means that we now think it reasonable to assume that a vote in the CCC will likely not happen before the end of the year, as per Figure 3 scenario 3.

Figure 3: Potential voting timeline scenarios



Regarding the technicalities of the voting process itself on the amendment to the Auctioning Regulation, an agreement in CCC requires a qualified majority, meaning 74% of the votes are needed. In practice, this means that 91 votes are needed to block a proposal out of a total of 345 votes (Figure 4).

Figure 4: Votes per Member State *

France, Germany, Italy and the UK	29
Spain and Poland	27
Romania	14
The Netherlands	13
Belgium, Czech Rep, Greece, Hungary, Portugal	12
Austria, Bulgaria, Sweden.	10
Denmark, Ireland, Lithuania, Slovakia, Finland	7
Estonia, Cyprus, Latvia, Luxembourg, Slovenia	4
Malta	3
TOTAL votes	345

Source: Deutsche Bank from European Commission; * Based on their population and GDP.

So far, according to press reports, the UK, France and Belgium have indicated they will support back-end loading (indeed, the UK has already said that it supports the cancellation of any allowances withheld for back-end loading). Poland does not support back-end loading, and an official from the Czech Republic was also quoted some days ago saying that the Czechs would not support it either.

Overall, the majority of Member States have still to make up their mind on the question of back-end loading, and the current lack of visibility on further longer-term measures to improve the working of the EU-ETS – the back-end loading of allowances being a first step to be followed by a second step looking at longer-term structural reforms – appears to be an issue for some countries.

Conclusion on the timing of amending the Regulation

Although on a best-case scenario we think a vote to back-end load allowances in the CCC could still take place on 15 November, for the reasons outlined above we do not think this is likely.

In our view it is more reasonable to assume that the Council will reach agreement only in time for a vote in its 19 December meeting, such that on the assumption that Parliament will have voted on the Directive in its plenary session of 19-22 November, the earliest date by which the CCC will realistically get to vote on the amendment to the Auctioning Regulation will be January 2013.

Once a vote in the CCC on the proposal to back-end load allowances is secured, a three-month scrutiny period would start during which the Parliament and the Council would be empowered to block the proposal on one of the following grounds:

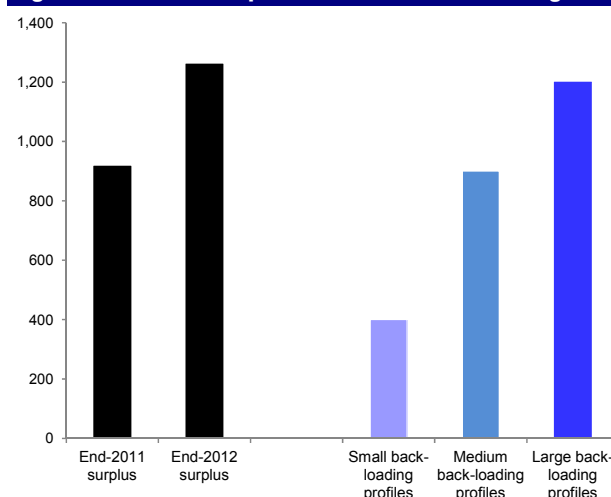
- (i) if it exceeds the Commission's implementing powers;
- (ii) if it is not compatible with the aim or content of the legal act;
- (iii) if it exceeds the EU's powers or remit.

No such opposition by the end of the three-month scrutiny period is interpreted as tacit agreement from the Parliament and the Council (as explained in our report *Changes to Phase-3 auctioning profile: a note on timing*, 3 August, the timing to the entry into force is then flexible, and we expect here the work to be done quickly).

*Finally, we would note that there is one important caveat to all this: if the Commission were ultimately to decide that only its own final endorsement of the CCC vote on the Auctioning Regulation needed to wait until the end of the three-month scrutiny period preceded by a change to the Directive, it would still be possible for a vote on the proposed amendment to the Auctioning Regulation to be held in the CCC **before** Parliament and Council have voted on the proposed amendment to the Directive. As a result, there is still a possibility that we could have clarity on the whole back-end loading process by the end of the year, as per the Commission's wish.*

What about the volume to be back-end loaded?

The Commission's Staff Working Document published in July developed three working assumptions as regards the volume to be back-end loaded: (i) 400m EUAs, (ii) 900m EUAs and (iii) 1,200m EUAs and indicated other options were conceivable. However, the wording chosen in that document (with the 400m EUAs back-end loading being the "small back-loading profiles", the 900m EUAs back-end loading being the "medium back-loading profiles" and the 1,200m EUAs back-end loading being the "large back-loading profiles") seems to indicate the order of magnitude of what could be the minimum and the maximum proposed numbers.

Figure 5: Phase-2 surplus* and back-end loading

Source: Deutsche Bank; * With the unused CER/ERU quota.

By the same token, the Commission estimated earlier this year the build-up of surplus allowances to be in the order of 900m EUAs to date (Figure 5).

We think it should not be interpreted at this stage as being the number that will finally be proposed by the Commission, and we highlight three main reasons for this.

First, the Commission made clear it will take due consideration of stakeholders' submissions before deciding on a number. Second, the Commission is not trying to precisely make up for the surplus in Phase 2 or even the combined projected Phase-2/Phase-3 surplus. Finally, the Commission indicated that flexibility was required in any case, and that a certain buffer of allowances would ensure a proper functioning of the market. As such, Commissioner Hedegaard was quoting saying:

"What we have been saying is that the surplus is up to 1.4 billion, but I understand from the technical experts we have to have certain room. You cannot eat up all the flexibility in the system, so 1.2 billion as far as they can see, that's probably the maximum" (Reuters)

Longer term structural measures

On 19 April, when shifting the immediate debate from the implementation of a set-aside of allowances to the consideration of a back-end loading of allowances (see our report *ETS Reform Should Not Be Set Aside* from 12 April 2012 for more details), the Commission made clear discussions on a set-aside or other longer-term structural reforms had not been dropped.

At that time, Commissioner Hedegaard announced that the first of the annual reports on the functioning of the EU-ETS foreseen under the Directive would be brought forward (it was initially due in 2013).

The Commission then said in May that that report would look at longer-term structural measures, such as a set-aside or a strengthening of the 2030 target, and then indicated on 25 July that it intends to release this report before the end of the year.

According to *Reuters*, an EU source pointed in the last few days to a publication of the expected Report on the functioning of the EU-ETS in November. This would indicate that a consultation period on the report would probably not be opened.

Also, in a context where many Member States expressed their concerns on taking a decision on the proposal to back-end load allowances without having the full picture of further potential longer-term reforms, the publication of this report in November would be very timely, as it should help Member States make up their mind on the proposal to back-end load allowances.

Outlook for prices unchanged

We continue to see EUAs trading in a range of €6-8/t until a political agreement on the clarification to the Directive is reached, but assuming the necessary votes occur in accordance with the timeframe we have set out above – and that they support the Commission's proposed amendment – the market's reaction will ultimately depend on the quantity of allowances withheld from the pool to be auctioned over 2013-15.

So far, the Commission has given three possible orders of magnitude for the quantity of allowances to be withheld, (i) 400m, (ii) 900m, and (iii) 1,200m.

In our view, a number around 400m would be a disappointment to the market and would risk seeing prices trade lower than current levels, while a number close to 900m or 1,200m should in our view be enough to push prices back towards €15/t or higher over 12-18 months following a vote to this effect (see our report *ETS Reform Should Not be Set Aside* for a detailed analysis on this point).

However, we remain of the view that a temporary set-aside of allowances of the kind being considered under the proposal to re-profile the auctioning would in and of itself have only a temporary impact on prices.

As a result, we think the medium to longer-term outlook for EUA prices continues to depend on the Commission's finding a permanent solution to the over-supply in the EU-ETS (again, see *ETS Reform Should Not Be Set Aside* for a more detailed account of our argument on this point).

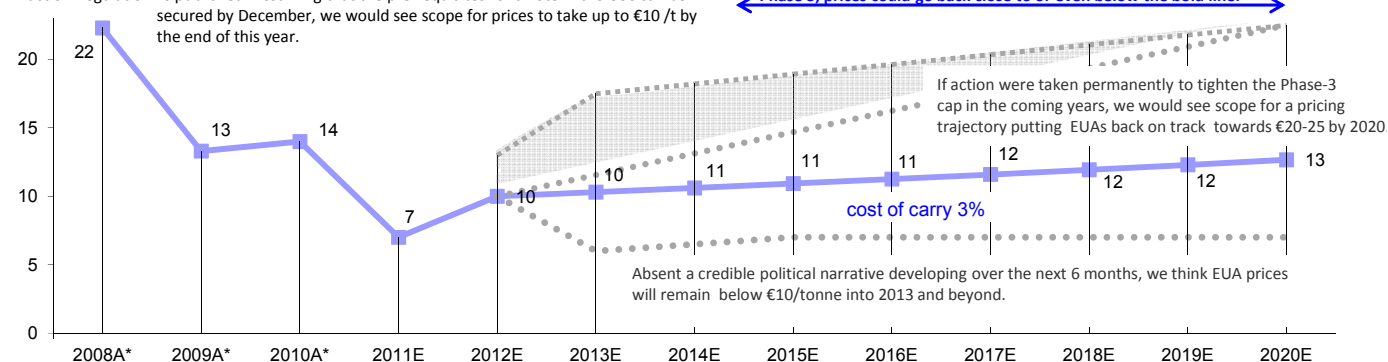
Isabelle Curien, (33) 1 4495 6616
isabelle.curien@db.com

Mark C. Lewis, (33) 1 4495 6761
mark-c.lewis@db.com

Figure 6: DB base-case scenario for year-end EUA prices*, 2008-20 (€/EUA)

We would expect Dec-12 EUAs to trade at €6-8/t in Q4 2012 unless and until an agreement to the clarification to the Directive is voted upon and/or the definitive proposal for an amendment to the Auction Regulation is published. Assuming that the pre-requisites for a vote in the CCC can be secured by December, we would see scope for prices to take up to €10 /t by the end of this year.

Potential uncertain price zone in case of a change of the auctioning profile but with no certainty on other longer term structural measures .
In case of a temporary set-aside over 2013-15 reintroduced later in Phase 3, prices could go back close to or even below the bold line.



Source: Deutsche Bank; *The prices shown for 2008-10 are the actual average prices over the course of the year, all other prices are either year-end outcome (2011), or year-end forecasts.

Appendix 1

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Global Head of Research

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Head
Global Research Product

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Global Head
Fixed Income Research

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Company Research

Asia-Pacific

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Regional Head

Germany

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Regional Head

Americas

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Regional Head

Europe

Richard Smith
Regional Head

Principal Locations

Deutsche Bank AG London

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London EC2N 2EQ
Tel: (44) 20 7545 8000

Deutsche Bank AG New York

60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250-2500

Deutsche Bank AG Hong Kong

Filiale Hongkong
Intl. Commerce Centre
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Hong Kong
tel: (852) 2203 8888

Deutsche Securities Inc. Japan

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Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Tel: (81) 3 5156 6770

Deutsche Bank AG Frankfurt

Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank Ltd.

Aurora business park
82 bld.2 Sadovnicheskaya street
Moscow, 115035
Russia
Tel: (7) 495 797-5000

Deutsche Bank AG Singapore

One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

Deutsche Bank AG Australia

Deutsche Bank Place, Level 16
Corner of Hunter & Phillip Streets
Sydney NSW 2000
Tel: (61) 2 8258 1234

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