

# EU ETS: A Practitioner's View

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# Centrica's Interest in EU ETS

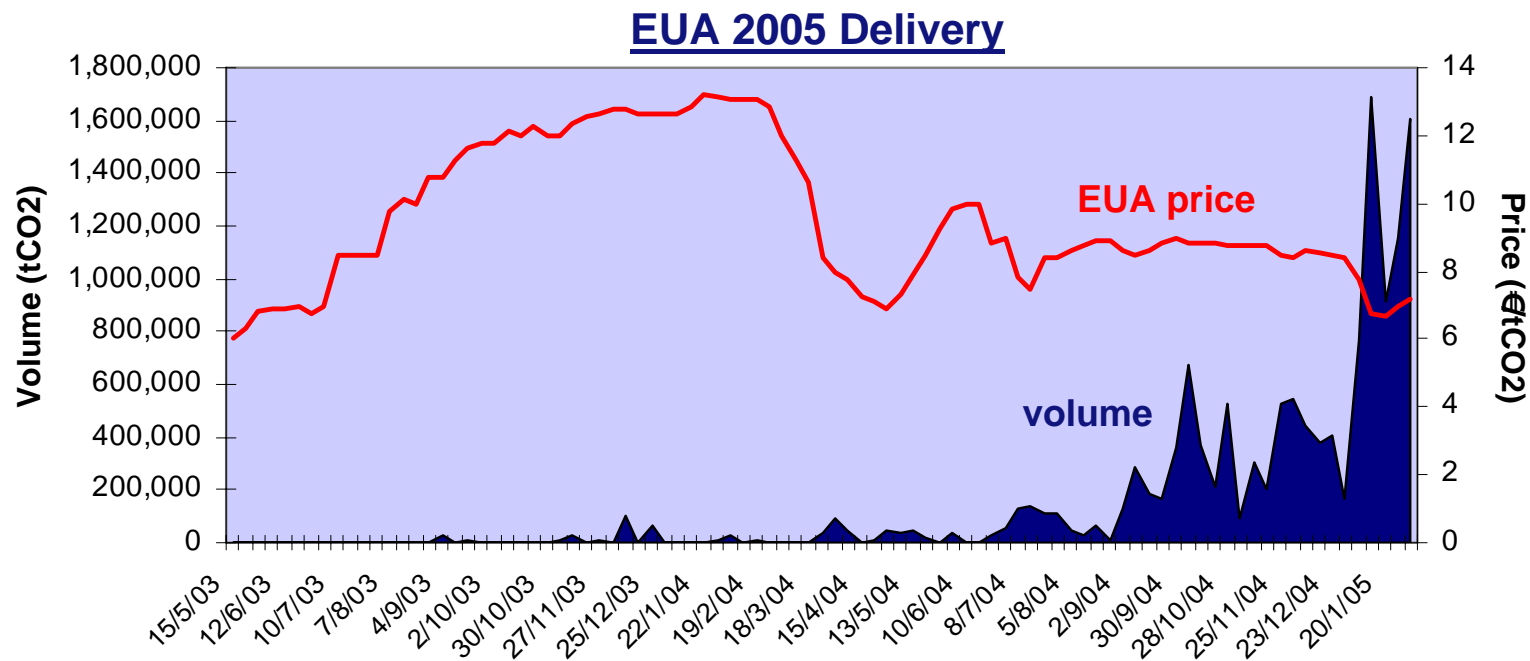
- As a participant
  - 7 CCGT power stations
  - Spalding tolling agreement
  - 2 on- and 2 offshore gas facilities
- As a trader (adding EUAs to commodities we trade)
- As an electricity retailer (through impact on wholesale market)
- As an independent retailer (in Spain and Belgium)
- As a new entrant generator (Langage development site)
- As a renewables developer (building on- and offshore windfarms)

# Steps to Compliance

- Application for site-specific GHG emissions permits
- Submission of installation-specific historic data (1998-2003) to enable calculation of CO<sub>2</sub> emissions baseline
- Independent verification of submitted data and emissions calculations
- Legal requirement to monitor and report CO<sub>2</sub> emissions from 1 January 2005 - expect increased drive towards measured emissions - increased burden on installations, in particular, offshore facilities
- Awaiting allocation of EUAs - dependent upon resolution between UK Government and European Commission
- Once allocated, allowances will be pooled and managed centrally
- By 30 April each year, allowances to offset site-specific emissions will be re-allocated to installations

# As a Trader

- Contracts complicated by 3 standard MAs - IETA, EFET, ISDA - Centrica utilising all 3
- Trading since February 2003; Centrica active since Q1 04
- 18 counterparties in 8 Member States and in excess of 1.5 million tCO<sub>2</sub>



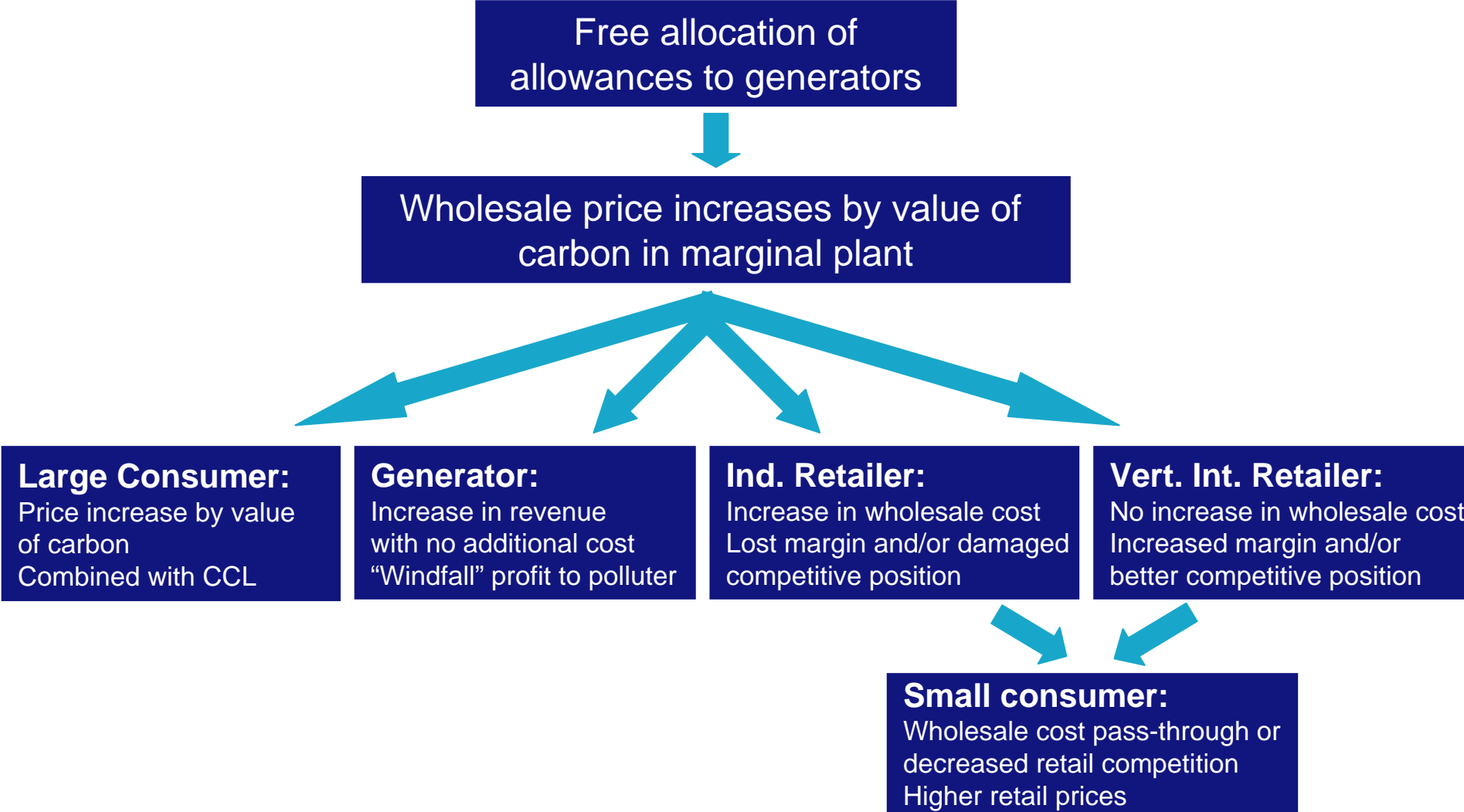
# As a Trader - Going Forward

- Integration of trading into trading and risk management systems
- Development of spot market
  - 7 Feb 2005 - 1st spot trade between Shell and Energi E2
- Development of options market
- Cross commodity trading (e.g. power contracts with embedded EUA pricing)
- Exploration of alternative compliance mechanisms:
  - CDM - generates CERs through the reduction or avoidance of GHG emissions in developing countries
  - JI - generates ERUs, which are transferred between developed countries, in return for investment in emissions reductions

# As an Electricity Retailer

- Decision to allocate EU ETS allowances free of charge avoids damaging EU competition (and retains EU industry)
- However, power sector is NOT a globally competitive market
- Power generators will pass value of allowances through to power price - same as fuel cost
  - this is true whether allowances are allocated free or paid for
- Effect of increased wholesale prices on electricity retailers dependent upon level of vertical integration
- EU ETS will create winners...
  - net generators benefiting from wholesale price rises
- ...and losers
  - independent retailers (+ energy intensive users) fully exposed to the wholesale price rises

# Impact of Free Allocation on Retail Competition



# Centrica's Retail Business

- Perception that Centrica is disadvantaged due to lower asset cover, however:
  - 1 Centrica's asset portfolio (inc. Spalding) currently provides more than 80% of British Gas' residential customer demand; maximum potential of over 90%
  - 2 High level of cover already in place for phase I and moderate CO<sub>2</sub> prices expected in early years
  - 3 Perceived advantage of existing coal plant overestimated due to a number of factors:
    - Any windfall in the near term is capped at new entry price (if free allocation is given to new entrants)
    - Increased auctioning in later phases
    - Large Combustion Plant Directive

# Across Europe

- Scheme introduces perverse outcome - the more competitive a market structure, the more likely EU ETS is to create distortion
  - “expect Northern European utilities [...] to benefit more than Southern European utilities, as [...] it is more likely that the CO2 price will be internalised into electricity prices in those markets”
  - “in very concentrated market structures and/or markets with price intervention, i.e. most of Southern Europe, we do not think that ETS has had any pricing impact”
  - “Overall we see German and the competitive east European utilities [...] to come out particularly well from ETS up to 2012”

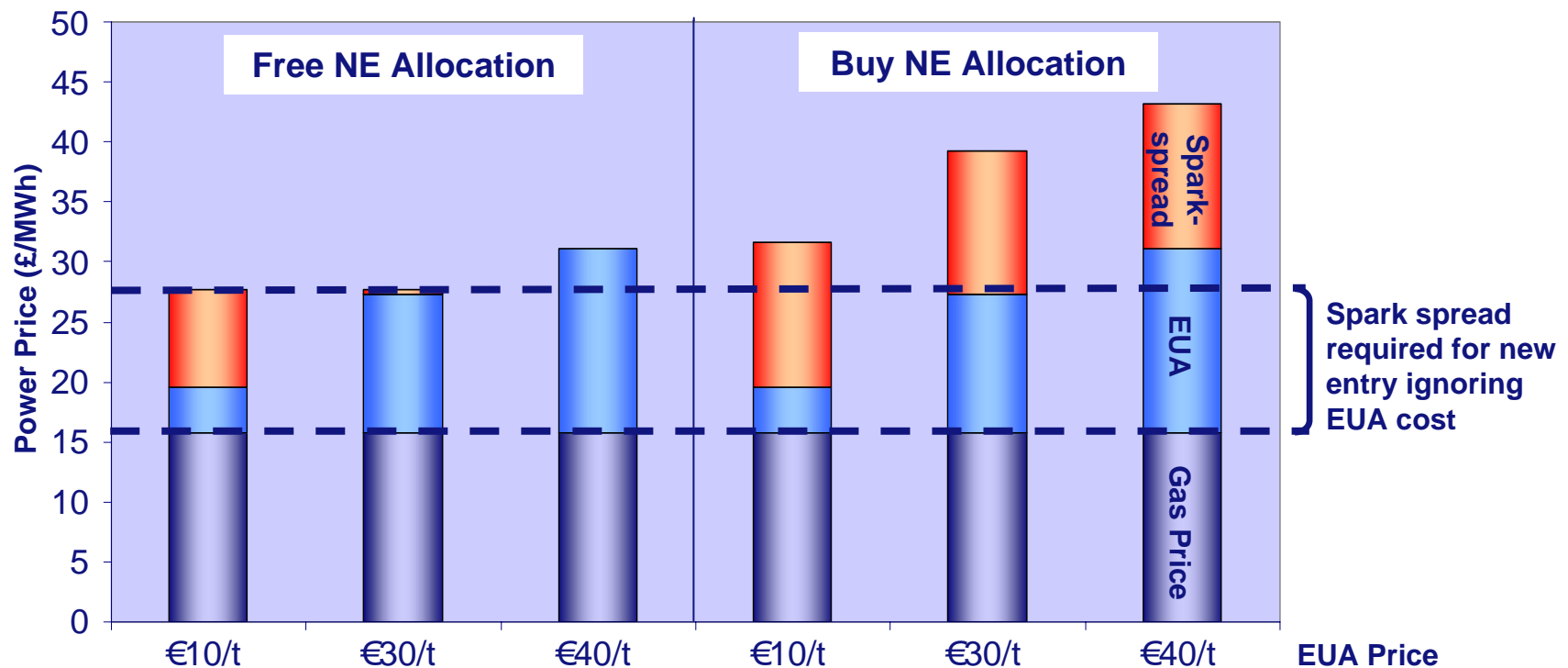
Source: UBS, Feb 2005

## As a New Entrant

- Already granted land and consents for development of gas-fired power station
- As such, phase II treatment of new entrants absolutely crucial
- Directive requires incumbents to receive at least 90% of allowances free of charge in phase II - difficult to see this changing
- New entrants will enter market when price signals stimulate good rate of return
- If required to buy allowances, price level at which new entry is initiated will increase
  - Grants incumbents greater scope to increase their prices without threat of new entry (increased windfall)
- Conversely, granting new entrants allowances on the same basis as incumbents will help to cap wholesale power price (and windfall) at a more realistic level
- Vis à vis incumbents, which have no EUA price risk, it is anti-competitive to place this risk on new entrants

# Free NE Allocation Caps Wholesale Power Price

- For allowance prices below €20/tCO<sub>2</sub>, free allowances will effectively “cap” wholesale prices at new entry cost
- Arguments for free allocation hold true for as long as incumbents are allocated EUAs free of charge, i.e. impact on new entrants not diluted by full awareness of EU ETS



# Required Clarity Going Forward

- Centrica recognises that it is inappropriate for Government to set phase II rules now
- However, without key principles soon, industry decisions, in particular on new entry, will become very difficult
- 3 core principles identified as needing immediate consideration and clarity:
  - 1 auctioning provision;
  - 2 treatment of new entrants; and
  - 3 baseline methodology
- Government opinion on 2 and 3 will affect commercial decisions now and failure to provide early clarity and market-driven solutions will seriously affect the market and its objectives

# Baseline Methodology

- Grandfathering of phase I allocations - most appropriate methodology given available data and implementation time-scales
- Phase II very different - installations forewarned of scheme and meaning of baseline
- Applying a similar but updated approach for phase II allocations will generate perverse incentives - namely increased emissions now to lock in more favourable baseline
- Approach now looking less likely, but to avoid any 'unnecessary' increases in emissions, Government must notify industry early of any decision regarding updating
- Centrica considers two alternatives to updating:
  - retention of phase I baseline with some element of future projections
  - benchmarking
- Both offer the 'right' incentives and mitigate likelihood of gaming

# Conclusions

- Centrica is committed to EU ETS as a strong supporter of market mechanisms
- Signs are good in terms of market development - certainly in terms of trading
- Urgent need to resolve stalemate on allocations
- Potential to distort retail competition
  - Continual monitoring needed
- Awareness of decisions on treatment of new entrants
  - Early clarity needed for future investment
- Early clarity on key principles for phase II now a priority