CZECH FAT CATS 2011

Introduction

The EU emissions trading scheme (ETS) is the flagship climate policy of the European Union. First established in 2005 it covers some 11,000 installations - ranging from energy generation to steel production - which account for around half of the CO2 emitted by the EU each year, or 2 billion tonnes of CO2 equivalent. All EU member states are a part of the ETS and are affected in different ways by the policy. The Czech Republic is the 8th biggest polluter in the EU in the emissions trading scheme.

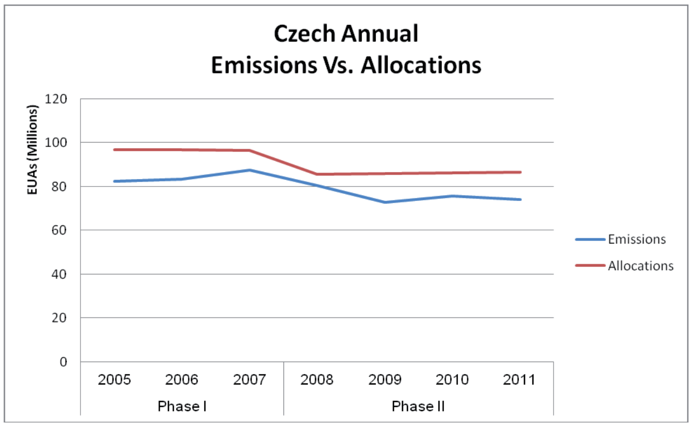
The EU ETS was designed to be the most cost effective way for companies to reduce their emissions. By putting price a on carbon companies would be inclined to reduce emissions as a way of avoiding the compliance costs involved with the EU ETS, instead investing in low carbon technologies as an alternative.

Unfortunately the ETS has not functioned as initially envisaged. Firstly the ETS was established using overly optimistic assumptions about what levels of economic growth Europe could expect. Secondly industry lobbied hard to protect themselves from the scheme. As a result many countries chose to insulate certain industries from the effects of the scheme by allocating them a generous number of free allowances. The power sector - who generally has more abatement options than other sectors - took on a greater burden of the scheme, allowing more free allowances to be given to the industrial sectors. While this trend is true of most countries, it's not the case for all. The Czech Republic is conspicuous in that CEZ, despite being a large power generator, is in the most favourable position of all Czech ETS participants. CEZ's position will be explored in more detail below.

Country Profile

Graph 1 shows that, from the start of the scheme, the number of allowances have been continuously above Czech Republic's actual emissions. While the first phase of the ETS was a test phase, excess allowances from the phase II can be used in subsequent phases without any restriction. Currently at this stage in Phase II the Czech companies have a surplus

Graph 1



of 41.2 million allowances which almost equals to yearly emissions of neighbouring Slovakia. While the unforeseen recession accounts for a significant proportion of this, over allocation is likely to be responsible to have played a significant role.

Fat cats

While some companies are being affected by the ETS, 85% of installations have a surplus of permits at this stage of phase II. Table 1 shows the top ten companies with the greatest surplus of carbon allowances in the Czech Republic. The top ten companies own more than ¾ of the total Czech excess allowances (see graph 2). These surplus allowances can be used either to hedge against anticipated future shortfalls or sold to gain revenues. However, the companies provide little information on what they do with extra allowances received for free. In 2006, the first from the top ten – CEZ - has made a public commitment to “reinvest profits from saved allowances within the EU emissions trading scheme into measures for the further reduction of greenhouse gas emissions, modernization and measures to improve the quality of the environment”[1] and promised to report annually on this. The last CEZ´s publicly available CSR report is from 2009 and neither specifies the amount of profits from surplus allowances nor the costs of initiated projects.2 Looking at the annual reports of the top three, one can find that while the 2010 report of CEZ includes its profits from sold allowances (CZK 1,6 billion), in the 2011 report this information is missing. Similarly, ArcellorMittal in the Czech Republic and Energetický a průmyslový holding do not inform on their revenues of ETS surpluses.

CEZ

Overall within the EU, steel and cement companies dominate the list of those with the greatest surpluses of allowances. This is not the case of Czech ones and CEZ is conspicuous in this regard. As the table above shows CEZ has the greatest surplus of allowances of all Czech companies. Since 2008 it has amassed a surplus of some seven million allowances, with an estimated value of CZK 2,6 billion (103m). This generous surplus means CEZ is insulated from the additional cost burden that the ETS would bring. It's no coincidence that CEZ had been left with this surplus, rather it's likely to have been a deliberate choice of the Government while developing their national allocation plan (NAP) – the document which set out each installations entitlement to free allowances. The rationale could be to prevent power consumers from paying higher prices, but as CEZ is majority state owned – the government could also stand to benefit from the surplus permits. CEZ is able to both use the advantages of partly liberalised Czech electricity market and its partial regulation. Given its dominance on the Czech market CEZ can sell its products for “German prices” while having to pay for the “Czech” costs. The price of electricity in Germany is relatively high due to costs of emissions allowances, other pollution costs and more gas share in their energy mix, while for CEZ these costs are relatively negligible.

From 2013 – the start of Phase III – the power sector will be obliged to purchase all their allowance requirements from auctions. There are exceptions to this rule, notably article 10c of the ETS Directive[1] which allows for a limited number

Table 1

Note: Arcelor Mittal has a higher value of permits despite a lower volume of them due to the way we have calculated the value. The volume of surplus EUAs in any year is valued at the average spot price that year, taken from BlueNext exchange data. Exchange rate EUR/CZK=25.

Rank	Company	Phase II Surplus EUAs (Million)	Estimated value (CZK billion)
1	ČEZ	7,1	2,58
2	ArcelorMittal	6,95	2,6
3	Energetický a průmyslový holding	5,81	2,27
4	Veolia Environnement	3,71	1,47
5	PKN Orlen	2,8	1,11
6	AGC Group	0,71	0,25
7	Sokolovská uhelná	0,67	0,28
8	MVV Energie CZ	0,54	0,21
9	Holcim	0,47	0,18
10	Mondi Group	0,44	0,19

1 http://www.cez.cz/edee/content/file/energie-a-zivotni-prostredi/cez-action-plan.pdf

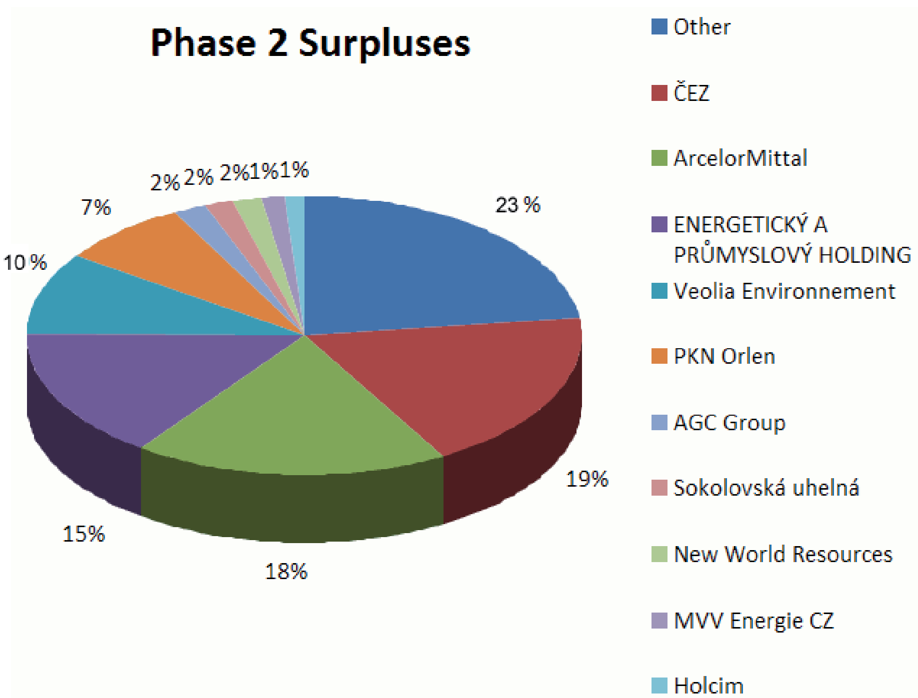
2 http://www.cez.cz/edee/content/micrositesutf/odpovednost2010/rozcestnik/index.html

3 Jan Ondřich and Martin Bebiak (2011): Power Abuse. ČEZ and the abuse of dominant market power. Candole Partners.

4 EU ETS Directive 2003/87/EC, resp. 2009/29/EC.

of free allowances to be issued for free to power generators. This rule exists specifically for those countries whose power generating capacity meets certain conditions: including being dependent on a single form of fossil fuel. As the Czech Republic produced 59%[5] of its power from coal in 2010, this allows it to apply for additional allowances. In September 2011 the Czech authorities have requested an additional 108 million[6] free allowances worth about 47,5 billion CZK for power producers after 2012. Almost 70 % of them (75 million) have been requested for CEZ. With more than 60 % of installed capacity owned by CEZ, and almost 75 % of country's electricity produced by CEZ in 2010, the Czech electricity market is one of the most concentrated in Europe. High market concentration hampers competition and increases the risk of undue competitive distortions. What is more, with such a large number of surplus allowances from Phase II, it seems likely that CEZ will financially gain from the ETS. It is therefore imperative that CEZ are transparent about how financial gains are invested.

Graph 2



Policy recommendations

- Call on the Czech Government to support a set aside of at least 2.2 billion allowances, with the aim to permanently remove them from the ETS.
- Call on the Commission to conduct a thorough review of the Czech application for free allowances to the power sector to examine whether it complies with the requirements of the EU ETS Directive and State Aid Rules.
- Call on the Commission to reject Czech applications for investments that may lead to a strengthening of CEZ's dominant market position.[7]
- Increased transparency of how CEZ and other benefiting companies fulfil the investments proposed in exchange for further free allocation after 2012.[8]

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5 http://www.tradingeconomics.com/czech-republic/electricity-production-from-coal-sources-kwh-wb-data.html
6 http://www.mzp.cz/C1257458002F0DC7/cz/derogace/$FILE/ozk-zadost_10c-20110819.pdf.pdf

7 Investments in power plants Chvaletice, Pocerady, Melnik and Ledvice.
8 Annex of the Czech Application for free allowances to the power sector.