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Implementing the EU ETS Directive: The allocation rules for the third trading period

The legislative process to define the allocation rules for the third trading period is entering its final phase. In this paper IFIEC outlines its position on three key issues which are of vital importance to EU competitiveness. IFIEC calls on legislators to consider these positions when taking their decisions.

1. **The *Historical Activity Level* must be a representative production level to meet the Directive's provisions: Sectors at risk of carbon leakage shall receive a 100% allowances free of charge based on ambitious benchmarks.**

Therefore: HAL should be defined as the average of the period 2005 until 2009 with the option to delete two years¹. This allows each sub-installation to exclude unrepresentative years and therefore results in a representative historical production level as a basis for allocation until 2020.

The Directive stipulates that sectors at risk of carbon leakage shall receive 100% allowances free of charge based on benchmarks.² The allocation to these sectors will be based on a benchmark and a reference production level. For the latter, the Commission intends to use a Historical Activity Level (HAL). IFIEC does not see HAL as the best solution,³ but if such approach will be chosen, the following is essential: To fulfill the aims of the Directive – protect competitiveness as best as possible within the total cap and effectively tackle the risk of carbon leakage – HAL must be representative of the installations' normal production levels. In other words, unusual production years must not be considered (i.e. those characterised by the economic crisis or a maintenance shut-down). Otherwise, the allocation until 2020 would be based on an artificially low production level leading to an allocation which is lower than intended. This would negatively affect competitiveness and increase the risk of carbon leakage.

The median of 2005 until 2010 does not result in a representative production level for most installations. Considering that production levels were very low for at least two of the six years due to the economic crisis (2008 and 2009), the median will be defined by the lowest production level in the other years (2005-2007, 2010). This is especially problematic if 2010 was also marked by the economic crisis – as is the case for several sectors - or a sub-installation carried out a maintenance shut-down during that period, which – statistically – was the case for two thirds of all sub-installations. The median could therefore lead to a significant shortage of allowances and inhibit the further operation of installations.

¹ Alternatively: Average of the period 2005 until 2010 with the option to delete three years.

² Art. 10a (12). Since the benchmark provides the efficiency incentive, allocation of 100% allowances free of charge according benchmark is appropriate.

³ IFIEC has called for a system based on actual production levels, because the use of a historic - outdated - production level will increase the system's complexity and lead to distortions (i.e. need to adjust allocation to changes in capacity level; risk of over- or under-allocation depending on the economic development; need to eliminate incentive for carbon leakage).

- 2. Allocation for new entrants: Growth of efficient businesses must not be disadvantaged. Therefore:**
- a. The condition of a “significant extension of capacity” shall be fulfilled if one of the following criteria is met: (i) an extension of a sub-installation’s capacity of 10% or more; OR (ii) a capacity extension leads to an increase of the allocation of at least 10,000 allowances calculated on the basis of the applicable benchmark.**
 - b. The ‘existing’ installed capacity shall be defined as the Historical Activity Level.**
 - c. The expansion of activities not listed in Annex I but associated with such activities must be considered properly when defining access to the NER.**
 - d. The Linear Factor must not be applied to the individual allocation for new entrants. Instead, the cross-sectoral correction factor should be applied, as for incumbents.**

The Commission intends to grant access to the New Entrants’ Reserve (NER) only in case of a capacity increase of at least 20%. This rule would significantly disadvantage and discourage growing companies and productions – and would thereby be in breach of the Directive’s aim to treat incumbents and new entrants equally. Effectively, the most competitive producers would have to pay for market share gains as most extensions will not meet the 20% threshold.⁴ Furthermore, the threshold disregards a common industrial practice: capacity creep with debottlenecking (consecutive expansions and/or optimisations). As the building of new factories will often not be a responsible investment under the present market circumstances, most growth will come from debottlenecking. In sum, the proposed threshold would cause distortions and would be a clear signal on a no-growth policy, which is not in line with the Commission Communication ‘Europe 2020’.

Instead, the growth of efficiently manufacturing businesses in the EU should be supported. With that aim in mind, the threshold for capacity extensions must be set at 10% at the level of the sub-installation (in line with recital 16 of the EU ETS Directive). This avoids distortions between permitting practices (one or more sub-installations per permit) and between companies (having one or more sub-installations on a site). In addition, a separate threshold must be included on the absolute increase of the allocation due to a capacity increase. This shall allow significant capacity extensions of large companies to qualify as new entrant – even if they do not meet the relative criteria on capacity increase due to their total size.

It is not possible to objectively define the ‘existing’ installed capacity on the basis of technical data. Therefore, IFIEC suggests to define the ‘existing’ installed capacity as the Historical Activity Level (HAL), which, importantly, brings consistency with the incumbents’ allocation. This definition is adequate because the utilisation of the new capacity will be considered through the application of the Standard Capacity Utilisation Factor (SCUF). Moreover, HAL is readily available and therefore its use would not cause any additional administrative burden.

Furthermore, production expansions of activities not explicitly mentioned in Annex I of the ETS Directive but directly associated with such activities (i.e. through the consumption of heat) must also be considered when defining access to the NER. Otherwise, the system would lead to perverse incentives in case of an extension of a so-called non-ETS activity: to meet the newly created heat demand, it would be more profitable to build a new boiler – which would receive allowances from the NER – rather than using an existing boiler more efficiently.

Contrary to some interpretations and in line with the treatment of incumbents, the Linear Factor of 1.74%/year shall not be applied to the individual allocation of new entrants but to the total cap. Then equal treatment between new entrants as compared to incumbents would be ensured.

⁴ For large sub-installations a capacity increase of 20% amounts to an increase in allocation of at least 150,000 - 250,000 EUAs.

3. Allocation must be consistent with the calculation of the maximum amount of allowances for free allocation.

Therefore: the allowances to be allocated for free for the heat production of electricity generators (irrespective whether allocation is to the consumer or the producer) and for their electricity production from waste gases should be taken from the amount for auctioning.

Since the definition of an “installation” provided in the EU ETS Directive is not implemented in EU Member States, it depends on the permitting practice whether certain emissions are considered to be associated to an “electricity generator” and thus calculated towards the amount for auctioning, or – if not – to the maximum amount for free allocation. While in some Member States an installation may be equivalent to a whole industrial site (wide definition), in other cases and other Member States each plant on an industrial site is considered a separate installation (narrow definition). As the narrow definition prevails for most combined heat and power plants and for electricity produced from unavoidable waste gases, these “installations” are regarded as electricity generators (even though the activities are directly associated with an industrial activity) and their emissions are calculated towards the auctioning cap. However, these installations will receive free allocation according to Art. 10a(1) and 10a(4). As the emissions of these installations are not counted towards the maximum amount of allowances for free allocation, this would lead to a distortion and possibly an unjustified early application of the uniform cross-sectoral correction factor (CCF). The CCF does not take into account CO₂ abatement potential and thereby weakens the effectiveness of benchmarking in preventing carbon leakage.

There are two possibilities to avoid this inconsistency:

- a. The maximum amount of allowances for free allocation is calculated correctly if the definition of an “installation” is implemented throughout the EU.⁵ Accordingly, the above named emissions would be part of the industry cap.
- b. The allocation must be carried out in such a way that it is consistent with the calculation of the maximum amount of allowances for free allocation. In other words, the allowances should be taken from the amount for auctioning if the emissions of that installation were counted towards that amount and vice versa.

As option a. does not seem feasible in the present time schedule, IFIEC calls for the implementation of option b.

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About IFIEC Europe

The International Federation of Industrial Energy Consumers represents companies in energy intensive industries in Europe for which the cost and availability of energy and power are significant factors affecting their ability to compete in world markets.

⁵ Art. 3e: ““installation” means a stationary technical unit where one or more activities listed in Annex I are carried out and any other directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution.”