Designing Emissions Trading as the route to a prospering low carbon EU economy

IFIEC represents the interests of industrial energy consumers in Europe. Energy prices, security of supply and sustainability are key concerns for these enterprises.

Emissions trading seriously affects energy intensive industries operating within the EU. Meeting the challenging CO_2-reduction targets technically and financially, as well paying the burgeoning electricity costs, puts high financial burdens on the industries represented by IFIEC Europe, which supports strict climate change and secure energy supply policies. By its very nature as an important contributor to low carbon solutions, EU industry is part of any EU climate change policy. A cost-efficient and effective EU-ETS, maintaining EU industry as the global low-carbon leader, is therefore the self-evident necessity. This drives IFIEC Europe's position regarding the draft proposal for the ETS Directive post 2012.

The following points form the essentials for a better scheme:

1. Avoiding the indirect ETS-effects

1.1. For industrial electricity consumers, the indirect effects of the EU ETS, i.e. the electricity price increase, represent a most significant financial burden. These high, indirectly caused costs must be avoided or neutralised to safeguard a level playing field in the global competitive market.

Alternative Solution 1: IFIEC method

1.2. Such high price increase can be avoided effectively, by applying the IFIEC method for allocating CO_2 allowances, as proven by ECOFYS[1]. Benchmarking based on actual production with a possible adjustment of the benchmark in future years can establish a system, that:

- guarantees the achievement of the CO_2 reduction target;
- incentivises taking carbon efficiency improvement measures equal to those under auctioning;
- saves up to €35bn annually for EU industry;
- saves more than €80bn for all EU consumers annually;
- reduces windfall profits effectively.

The IFIEC method

- The IFIEC method realises **cap and trade**.
- An ex-ante allocation based on a **benchmark,** free of charge.
- The allocation is linked to **actual production**. This is reflected in a subsequent year.
- The total **cap is guaranteed** by adjusting the benchmark forward in subsequent years.

1.3. Full auctioning as proposed by the EU Commission is the costly solution, since it consolidates EU-ETS' high indirect cost effects rather than limiting them. The IFIEC method, when used for electricity, effectively eliminates both the opportunity price impact and indirect cost effects of auctioning.

1.4. The IFIEC method could well be the approach for an effective EU-ETS to the benefit of the global climate, as well as the EU economy and its citizens.

1.5. Can the EU really afford to ignore an option for EU-ETS which delivers the same CO_2 reductions by setting equal incentives for low-carbon technologies as full auctioning, but at significantly lower costs for all consumers?

[1] ECOFYS: The IFIEC method for the allocation of CO_2 allowances in the EU Emissions Trading Scheme, March 2008. See www.ifieceurope.org

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Alternative Solution 2: indirect allocation

1.6. If auctioning CO_2 allowances to the electricity sector is the political choice for post 2012, EU industry will be hit by huge indirect effects, in addition to the direct consequences of EU-ETS. These are estimated by ECOFYS at a level of up to €35bn annually. Without an international agreement effectively restraining the wide range of global regions not affected by comparable CO_2-price effects, such high cost burden is bound to undermine the competitiveness of EU industry and needs to be countered.

1.7. Necessary compensation should be realised by allocating CO_2 allowances for the indirect electricity emissions to EU industry instead of auctioning them to the electricity sector. The quantity of CO_2 allowances to be auctioned by Member States to the electricity sector would have to be reduced to meet these industrial needs. The indirect allocation is on top of the normal allocation to industry and is based on an electricity benchmark that results in a fair compensation of the ETS' power price impact. The indirect allocation is granted only for the benchmark performance of the receiving industrial site. The electricity benchmark might also be used to stimulate CHP. The use of the site benchmark ensures that the incentive to reduce overall emissions – including the efficiency of the use of electricity – remains fully in place while the negative impact of increased power price for industry is compensated.

2. Free allocation for industry

2.1. In addition to the high indirect cost effects, industry, as part of EU-ETS, has to meet challenging CO_2-reduction targets set for the EU-ETS sector at -21% compared to 2005. To this reduction, the growth of production observed over the last years of 2% a year must be added. So the total CO_2 reduction target is in the order of 40%. To meet this target requires significant financial resources.

2.2. Auctioning means that industry also pays for the allowed CO_2-emissions; thus it faces an additional production 'fee' on top of the costs associated with its abatement obligation.

2.3. As long as there is no international agreement which effectively puts a similar target and burden on its global competitors, EU industry will be at a disadvantage internationally. This cannot be the aim of the EU ETS because of:

2.3.1. Firstly, the additional high auctioning costs do not contribute to the climate change policy targets because:

- Incentives to make efficiency improvement investments are not strengthened by the high cost base caused by auctioning, but only by potential cost differences (savings) achievable through an investment. These are exactly the same also in a lower cost benchmarking system as proposed by IFIEC (as proven by ECOFYS);
- The high cost base caused by auctioning increases the risk of carbon leakage. The exported CO_2-emissions in these cases would form a significant part of the CO_2-reduction target achievement. As a consequence, the need for abatement measures, which would really be a positive issue both for the EU to be the global low carbon leader, as well as for the global carbon balance (fuel shift, efficiency improvements, innovative technologies etc.), would be significantly lower.

2.3.2. Secondly, auctioning is not a necessary precautionary measure against the fear that industry could reap windfall profits from free allocation in future.

- The IFIEC method allocates CO_2 allowances based on actual efficient production, as a result of which there are no opportunity costs (proven by ECOFYS for the electricity sector, but also valid for other sectors).
- In the absence of opportunity costs, there is no potential for any cost pass through and windfall profits by the industries participating in EU-ETS.

2.4. Allocation based on benchmarks cannot be regarded as a light version of the EU ETS, but sets challenging and highly demanding targets for technology in industrial processes.

2.5. Free allocation based on benchmarks taking into account the actual production is the allocation method that sets effective incentives for CO_2-reductions while avoiding unnecessary additional costs for the industries concerned.

3. Actual production should be the correct basis for allocation

3.1. Allocating allowances based on benchmarks and historical production is just a new variation of historical grandfathering, which should be abandoned since it has caused the major flaws and distortions within EU-ETS in the 1st and 2nd trading periods.
3.2. Market share competition is distorted with a frozen allocation at the level of historical or standardised production as winners must buy allowances to expand and market-share losers are protected by possible sale of allowances.
3.3. Any growth after 2006 (with the exception of new plants on greenfield sites) – the latest foreseen production basis for allocation with benchmarks according to the EU Commission proposal –would need to be purchased if the link to historical production is chosen. This works exactly as full auctioning for any growth.
3.4. Having no free allowances for growth or plant expansions actually hinders the move to low carbon technologies, whereas no allowances after closure is an incentive to keep old, inefficient plants producing. A link to actual production would avoid these counter-productive, perverse incentives.
3.5. A frozen free allocation based on historical or standardised production and benchmarks does not address the threat of leakage of emissions – which is exactly what free allocation is intended to avoid.
3.6. The link to actual production excludes effectively any potential windfall profits (as proven by ECOFYS).

4. No division of industry in exposed vs. non-exposed sectors

4.1. Free allocation to industry based on the above reasoning must apply to all industrial sectors concerned.
4.2. All of the industrial sectors within ETS are selected because of their carbon intensity. All have to meet stringent CO_2-reduction targets and spend significant financial resources. As a consequence all are at a disadvantage compared to global competitors.
4.3. Any criterion which might be applied to distinguish between exposed vs. non-exposed sectors is arbitrary (e.g. the chosen level of CO_2-price). None of the expert studies conducted is conclusive, nor is there any assurance that a new study will come up with clear-cut conclusions. Moreover, the expert studies so far assumed rather low CO_2-prices, e.g. € 20-40/ton while virtually all analysts assess a CO_2-price of € 50-70/ton by 2020. This means that significant leakage is much more likely than reflected in the studies, undermining European economy and Europe's credibility in the global arena.
4.4. Any distinctions would disaggregate complex industrial processes, lead to unequal treatment and result in unfair competitive distortions within the EU.
4.5. Disaggregation of the industrial ETS-sectors would add significant complexity to the scheme.

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