

Review of the EU Emissions Trading Scheme (ETS) Directive

- CEER response

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Executive Summary

In November 2006 the Commission published a Communication setting out the review process for the European Union Emissions Trading Scheme (EU ETS)¹. The Commission sought views regarding the following four key areas:

- expanding the scope of the scheme;
- increasing harmonisation and predictability;
- ensuring robust compliance and enforcement; and
- the involvement of third countries.

CEER welcomes the opportunity to contribute to this consultation process. CEER has, in the past, supported the EU ETS, as the most cost effective way to encourage a reduction in greenhouse gas emissions (GHG). The CEER response to the Energy Green Paper² called on the Commission to give priority to the emission trading scheme as a key instrument to tackle climate change within the energy sector and beyond, and has invited the Commission to add some issues in particular. We view the Commission's review of the EU ETS Directive as an opportunity to improve the schemes efficiency, increase certainty and remove perverse incentives. We consider this to be particularly important given the binding targets proposed by the Commission, as part of the Strategic Energy Review, to reduce GHG emissions by 20-30% by 2020 compared to 1990 levels.

The key points from the CEER response are set out below, grouped by the key areas upon which the Commission requested views.

Expanding the scope of the scheme

CEER supports the Commissions proposal to extend the EU ETS to the aviation sector and considers that the broadest possible coverage of the scheme will ensure that carbon abatement takes place at the most efficient cost. CEER is of the view that the Commission should extend the EU ETS to include all sectors and gases, clarify the extent to which new technologies will be incorporated and provide clarity on the combustion installations covered by the EU ETS. All of these amendments would ensure consistency of application of the EU ETS across Member States.

CEER considers that setting an EU wide cap on GHG emissions would provide a longer term framework for the EU ETS and therefore provide credibility, consistency and certainty to participants. In turn, this increased certainty would encourage the increased development and use of low carbon technologies.

¹ COM(2006)676, 13.11.2006 « Building a global carbon market – report pursuant to Art. 30 of Directive 2003/87/EC »

² CEER response to the Energy Green Paper, ref. C06-SEM-18-03, 11 July 2006
(http://www.ceer.eu.org/portal/page/portal/CEER_HOME/CEER_PUBLICATIONS/CEER_DOCUMENTS/2006)

CEER supports proposals to harmonise the current methodology for allocation of allowances. CEER also supports the movement towards full auctioning of allowances as this represents the most efficient way to allocate permits by recognising those parties that value the allowances the most. CEER considers that the current method of free allocation to new entrants distorts investment and that the current rules on plant closure create perverse incentives to continue to operate.

Compliance and enforcement

Harmonisation of compliance and enforcement schemes will ensure consistency in application of the EU ETS. In particular, harmonised reporting will enable a comparison of performance between Member States while independent verification will improve the credibility of the scheme.

Involvement of third countries

CEER considers that links with third countries will facilitate the emergence of a global emissions trading scheme, especially during the early stages of development of such a scheme. We also support the achievement of greater harmonisation in the use of Kyoto credits across Member States to increase flexibility in the scheme.

1 Review of the EU ETS Directive: CEER response

The Commission published a Communication in November 2006 setting out the review process for the European Union Emissions Trading Scheme (EU ETS)³. As part of the review, the Commission established the European Climate Change Programme (ECCP) Working Group to consult more widely with interested parties in addressing the issues identified by the Commission, namely:

- expanding the scope of the scheme;
- increasing harmonisation and predictability;
- ensuring robust compliance and enforcement; and
- the involvement of third countries.

CEER welcomes the opportunity to contribute to the Commission's Review of the EU ETS. The improved functioning of the EU ETS will be crucial in helping the EU meet its international obligations as well as meeting the proposed target contained in the Commission's Strategic Energy Review, to reduce greenhouse gas (GHG) emissions by 20-30% from 1990 levels by 2020.

CEER members, as part of their regulatory duties have objectives:

- to protect the interests of energy consumers;
- to support competitive energy markets; and,
- to regulate monopoly networks.

The review of the EU ETS Directive will have important implications for gas and electricity markets, which are overseen by CEER members as well as for consumers across Europe more widely.⁴

CEER notes that the Commission has announced that it will be taking advice from the ECCP Working Group on how to improve the functioning, as well as the environmental and cost effectiveness of the EU ETS, in light of the experience gained from the scheme's operation in the first phase.

In the past, CEER has supported the use of economic instruments as the most cost effective way to encourage the reduction in greenhouse gas emissions (GHG). We have also taken the view that a single price instrument will provide a transparent signal to allow businesses to make efficient investment decisions and assess the relative costs of energy efficiency measures against alternative means of reducing their carbon emissions.

³ COM(2006)676, 13.11.2006 « Building a global carbon market – report pursuant to Art. 30 of Directive 2003/87/EC »

⁴ Submission to European Commission on Energy Efficiency Green Paper, COM (2005) 265, Ref: C05-ENV-04-05, 28 March 2006

While reaffirming that the main objective of the EU ETS is reductions of greenhouse gas emissions in a cost-effective and economically efficient manner, the Commission's review of the Directive is an opportunity to improve the scheme's efficiency, increase certainty and remove any perverse incentives. Preservation of sound competition and promotion of effective and undistorted markets is of paramount importance to CEER and its members. In this context the following will be important for the EU ETS to deliver maximum potential.

In the increasingly liberalised energy markets in Europe, it is essential that the emissions trading market is liquid and transparent and does not provide the opportunity for distorting competition in the underlying commodity markets.

2 Current framework

The EU ETS is still evolving and the Review is an opportunity for the EU to ensure the scheme will deliver carbon savings where they are most efficient. The results from the first compliance period (2005-2007) provided a valuable learning phase. However the volatility in the market suggests that some adjustment in the design of the scheme could improve its effectiveness in the longer term.

CEER is concerned that some aspects of the present design undermine the incentives to trade and reduce the efficiency of the scheme. The issues we identify as being most important are as follows.

- The relatively short time period for which allowance caps are set does not provide long-term certainty and predictability;
- The restricted coverage of the scheme does not provide a strong incentive for abatement to occur at the lowest possible cost;
- Greater harmonisation across Member States would be likely to result in a more robust and efficient scheme; and
- The free allocation of allowances creates distributional impacts and is not the most efficient method of allocation.

Ensuring the scheme functions efficiently from 2013 is even more important given the publication of the Strategic Energy Review, which proposes a core energy objective for Europe to reduce GHG emissions by 20-30% by 2020 compared to 1990 levels. The IPCC's updated projections of climate change, and the conclusions of the Stern Review in the United Kingdom, have highlighted the need to reduce emissions and place greater emphasis on the role of trading schemes.

The current Review offers the chance to improve the structure of the scheme and set a global standard on the design of trading schemes. This will assist the achievement of GHG emission savings, influence the development of an international carbon market and help to meet security of supply goals.

CEER views on each of the issues which the ECCP Working Group will be addressing are set out below.

2.1 Scope of the Directive

2.1.1 Expansion of the scheme to other sectors

The scheme currently covers major stationary sources of emissions but does not cover some sectors which are important in terms of emissions and, recognising this, the Commission has proposed that emissions from the aviation sector will be included in the scheme. The absence of other sectors and gases from the EU ETS means that abatement may not be occurring at the lowest possible cost across the economy as a whole.

While CEER's interests are principally in the energy sector, we recognise that it could be beneficial to increase the scope of the Directive with further expansion of the scheme to cover other significant sectors. The broadest possible coverage for the scheme will provide an incentive for abatement to occur at the lowest cost. Where new sectors are introduced to the scheme, we consider that it may be appropriate to make use of 'shadow' schemes in order to reduce distortions to other sectors given the lack of valid historical datasets to inform initial allocations. If full auctioning of permits is not achievable for the next phase, this would be particularly important for the energy sector where electricity prices can clearly be affected through such distortions.

Currently the Directive applies to individual installations at the point of emission. However including other sectors may require the Directive to be applied differently (e.g. for small installations the obligation could potentially be moved to the fuel supply point). These adjustments and differences in the application of the Directive will add to the complexity of the scheme and it will be important to take this into consideration when deciding whether to broaden the scope.

2.2 Combustion and small installations

CEER would welcome greater clarity on the specific types of combustion installations that are covered by the Directive. This should ensure a consistent approach is taken across Member States on the interpretation of combustion installations and how the Directive is applied.

Environmental improvements should be made where they are most efficient, it is important to consider the cost effectiveness of covering small installations in EU ETS, and the administrative burdens on small installations in participating in the scheme. The Directive could potentially exclude small installations or impose the obligation on the fuel suppliers, which would reduce the overall administrative burden. The benefits of these options would need to be weighed against increasing the complexity and scope of the scheme.

2.2.1 Other sectors and gases

The scheme should be expanded to cover emissions from other sectors and gases if it is feasible. The aim should be to remove any perverse incentives created by emissions which are not currently captured by the scheme. For example, direct emission of methane is currently exempt from the scheme, but combustion of that

methane in a cogeneration plant creates an EU ETS obligation. We suggest that the Commission explores all possible options, including the development of 'shadow' schemes where appropriate, and seeks agreement across Europe on the scheme coverage to avoid any distortions that may arise from inconsistent coverage.

2.3 Unilateral inclusion of additional activities and gases

Member States are currently able to unilaterally "opt in" additional sectors and gases, subject to approval by the Commission. However, doing so, could distort competition between Member States. A coordinated and harmonised approach across all Member States regarding the sectors and gases that are subject to the scheme would remove such concerns.

2.4 Carbon capture and geological storage

The extent that carbon capture and geological storage (CCS) activities will be recognised as carbon abatement under the EU ETS will require agreement across Member States. Given the Commission's proposal within the Strategic Energy Review that all coal and gas fired plants will need to be fitted with CCS by 2020, there is likely to be strong support for its recognition as an abatement technique under the EU ETS. However, before this can be done, it will be necessary to undertake a thorough assessment of CCS to ensure that the Commission is satisfied that CCS is technically, economically, and environmentally feasible.

3 Further harmonisation and increased predictability

Greater harmonisation of the scheme will make it less likely that special interest groups will have the ability to pressure individual Member States to put in place measures that distort incentives. Harmonisation is likely to result in a more robust and efficient scheme rather than a scheme under which participants are simply compliant with minimum standards.

3.1 Setting of the cap

An EU-wide cap on the level of GHG emissions would provide greater credibility and consistency. The level of the cap could be set to meet Europe's internationally agreed total emission reduction targets and the proposed core energy objective of 20-30% reduction in Europe's GHG emissions by 2020. A political agreement would be required to set the cap for the EU as a whole, with detailed negotiations among Member States on the distribution of the cap.

The short-term nature of the current targets creates uncertainty that may mean expensive short-term abatement options are implemented in preference to relatively cheaper long-term abatement options. Long-term abatement options are likely to require substantial capital investment which may only provide sufficient return if emissions are valued over the lifetime of the investment. In the absence of long-term abatement targets, investors may be unwilling to commit the required capital as the return is too uncertain. As a result, the only abatement options which are available are short-run options such as fuel-switching or reducing production.

Greater certainty could be provided by longer phases, or for targets to apply for two or more phases. This could provide greater certainty in regard to the level of the cap, but would allow other aspects of the schemes to evolve over early phases.

However, a design with longer phases must ensure contestable markets and cannot create barriers to entry. One way could be to design a scheme with both longer and shorter phases where allowances are allocated, say, fifty-fifty between each type of phases.

3.2 Predictability

Certainty and credibility of the EU ETS are essential to foster further development and use of low carbon technologies as they require long term investment. There needs to be a predictable framework where investors are confident that commitments are credible, as political uncertainty could severely undermine investments. Facing uncertainty, investors may opt to invest in lower cost fossil fuel based technologies.

Adjustments might be required as the scheme develops and expands to ensure there are not any inconsistencies or perversities, however the overall framework should remain consistent.

3.3 Allocation of allowances to sectors and installations

CEER supports the intention to harmonise the allocation methodologies for each sector of the scheme across all Member States to ensure consistency and transparency of the scheme as well as improving its simplicity. CEER considers that there are four key issues that could be addressed through the review of the EU ETS directive, associated with the current allocation methodology. These include:

- Auctioning of allowances;
- The current method of free allocation;
- Treatment of new entrants; and
- Rules on plant closure.

Each of these are discussed in turn below.

3.3.1.1 Auctioning

CEER supports a move to greater auctioning of allowances as soon as possible. Full auctioning of allowances would be the most efficient mechanism for allocation

and would reduce the administrative burden of implementing a methodology for free allocation. Auctioning is the most efficient means of allocating allowances as it ensures that allowances are allocated to those who value them the most. Free allocation increases profits to generators as the opportunity cost of allowances is incorporated into the electricity price. Auctioning reduces this effect, which may improve public acceptability of the scheme particularly at times of high energy prices, and ensures the cost of emissions is incorporated in business decisions.

The revenue from the scheme can be used in a number of ways, to offset other taxes or to compensate those consumers most affected by increases in energy prices. Alternatively it could be used to fund policies designed to increase the long-term certainty of the carbon market. Auctioning the allowances could also resolve the issues regarding new entry reserves and closure and may in turn achieve other benefits in respect of security of supply.

3.3.1.2 Free allocation

As noted above, CEER does not support free allocation of allowances. CEER recognises that it may be necessary to provide some allowances by free allocation as a transitional measure towards full auctioning in due course, given different legal or political barriers in some Member States (for example: as is currently the case in Germany). However, if free allocation is to be retained, even as a transitional measure, issues in the allocation need to be resolved. Allocation on the basis of historic emissions or relatively simple benchmarks is likely to be administratively simpler and less contentious than allocation on the basis of projections. Overall, CEER agrees that 100% free allocation of permits is not a desirable or acceptable approach.

The use of benchmarks for the electricity generation sector has a number of benefits compared to other possible allocation methodologies. Benchmarks based on best practice fuels and technologies introduce simplicity, transparency, and predictability into the allocation process as well as reducing the associated administrative costs. The use of a benchmark system minimises the effect of anomalies in historic data and reduces the incentives for gaming, as the impact of an individual plant history on its own allocation is significantly reduced. However, they can allow parties to increase their profits in markets where the allowance price is passed on to the consumer. Benchmarks should not be seen as mechanisms that provide incentives for particular action. The driving force to change behaviour and to influence investment in the ETS is the allowance price.

3.3.1.3 New Entrants

As noted above a move away from free allocation of allowances would also remove the need to have new entry arrangements as all market participants, new and incumbent, would face the same cost of carbon in their investment and operational decisions. In the event that there was free allocation of allowances, new entrants should still be required to buy allowances to avoid the distortion of investment incentives and therefore ensure market efficiency and environmental integrity. In this regard, the existing practice in most Member States is allocation of free

allowances to new installations which come within the boundaries of the scheme. This essentially acts as a subsidy to investment in new sources of carbon dioxide emissions which is not available to low-carbon technologies. This could result in over-investment in carbon intensive technologies and reduced investment in low-carbon technologies. This is exacerbated by the lack of long-term targets discussed above as uncertainty about whether or not a carbon price will exist in the future may incentivise investors to invest in lower cost fossil fuel based technologies, knowing that in the short-term they will receive a free allocation of allowances.

CEER, however, recognises that there is pressure from many Member States to continue the practice of issuing free allowances to new entrants in order to support competitiveness, security of supply and equity as well as other non-environmental objectives. CEER considers that effects on the environment can be treated in much the same way as other costs and the impacts should therefore be reflected through pricing mechanisms. As such, impacts on security of supply are not likely to be a major concern in respect of allocating permits through auction mechanisms – unless political decisions are taken at a national level that mean companies are not exposed to the full costs in prices. If this option is followed it is important that there is a harmonised approach to new entrants across Member States to ensure greater consistency and comparable competition across the EU.

The treatment of new entry is an area where there is a strong risk that decisions made within the EU ETS may have a distortionary effect on markets. New entrant reserves may potentially be too generous compared to incumbents, given that new entrants, like incumbents, will have an incentive to overestimate their requirement for allowances. However, as there will not be historical data regarding the specific operations of new installations, it is more difficult to verify or refute the requirements of new entrants as opposed to those of incumbents. If new entrant reserves are to be used there should be simple and transparent mechanisms for allocating allowances, based on benchmarks that cannot be gamed. Any such mechanism should be harmonised across all Member States.

Any definition of a new entrant should remain as narrow as possible in order to maintain the incentives of the scheme. A wide definition would lead to an administratively complex scheme and is contrary to the principles of emission trading. The mechanism should seek to minimise any perverse incentives.

3.3.1.4 Installations that close

Under the current arrangements, a facility that is permanently closing must forfeit its right to any undistributed emission allowances. CEER considers that this requirement could create perverse incentives to keep the plant open to retain access to the free allocation of allowances where otherwise it would be economically efficient to close the plant.

It has been argued that this approach to closure is beneficial for security of supply as it maintains generation capacity on the system. However, if a plant remains on the electricity system, but only with a limited ability to generate, the apparent surplus capacity may discourage investment in new installations. The existence of surplus capacity may distort electricity prices and reduce the incentive for new capacity to be brought on to the system. If the old capacity is not capable of running beyond minimal levels, this may increase the risk of supply interruptions at peak times. These inefficient decisions represent a real loss to the efficiency of the scheme and will result in a higher cost to consumers, creating a false level of capacity which could be detrimental to security of supply.

CEER's view is that the most economically efficient approach would be for plant owners to retain emission allowances if a plant closes, making closure a legitimate emission abatement option. The excess allowances could be used to increase production from other facilities within that operator's portfolio, or sold to others, increasing the liquidity in the allowance market. This will remove the incentive for incumbents to keep obsolete plants open, and provide more accurate signals of supply requirements.

However, we recognise that there will be pressure in many Member States to require closing installations to have some obligation to return allowances. This could be mitigated by allowing the transfer of allowances to new, more efficient plants, and by ensuring harmonisation of closure rules across the scheme.

3.4 Monitoring and reporting

A more structured and regular release of information may help prevent the carbon price volatilities observed in 2005. Accurate and timely information on actual emissions needs to be made available to all market participants.

Countries releasing their emissions data ahead of the EC's scheduled release date caused large variations in the carbon price. Ensuring a harmonised date, where all market participants receive the information at the same time should reduce uncertainty. CEER consider that it is necessary to review the information being made available to the market at regular periods to ensure that the operation of the scheme is as transparent as possible.

4 Robust compliance and enforcement

Compliance and enforcement are essential for the effectiveness of the scheme and to provide credibility. Harmonisation across Member States will be important for consistency. However it will be important to balance any requirements with the additional administrative burdens this places on participants in the scheme.

4.1 Monitoring and reporting

Harmonised reporting and monitoring will allow performance to be easily compared between Member States and should increase the transparency of the scheme. We would support EU-wide uniform standards on monitoring and reporting.

4.2 Verification and compliance

Compliance and independent verification of emissions is vital to the credibility of the EU ETS. This would benefit from a harmonised approach across Member States on the accreditation of verifiers.

5 Linking with emissions trading schemes in third countries, and appropriate means to involve developing countries and countries in economic transition

5.1 Possibility of linking the EU ETS to schemes in third countries

Developing links with third countries may help to facilitate a movement towards a global emissions trading scheme in the future. Harmonising and linking the different schemes between countries early in their development should simplify the process of creating a global emissions trading scheme in the future. CEER believes that decisions in this area are beyond our area of interest and are a matter for the EU and for Member States. However, in general, we favour any increase in the flexibility of the system, as this will ensure emission savings occur where they are most efficient. A well functioning international abatement market allows climate change targets to be met at minimum costs. This should lead to a lower allowance price as well as less impact on European energy consumers.

5.2 Developing countries and countries in economic transition

We consider that decisions regarding the use of Kyoto mechanisms are political decisions. However, we observe that the ability of participants to surrender credit from Kyoto Protocol flexible mechanisms allow an increase in the flexibility of the system and generate a possible reduction in the allowance price, therefore reducing compliance costs and increasing liquidity of the system. We would therefore support greater harmonisation across Member States in the use of Kyoto credits. The contribution projects are making to shift economies to more sustainable paths, particularly due to the growth in emissions from developing countries and their increasing contribution to climate change.

Having said the above, we also note that every good purchased in Europe, but produced outside the EU, should be labeled following EU environmental criteria. If not, there is no guarantee to really reduce global emissions. There is instead a concrete risk that the only achievement will be to move the polluting industry outside the EU.