European Commission stakeholder consultation on Emission Trading System (ETS) post-2020 carbon leakage provisions

Commission Introduction

The EU emissions trading system (EU ETS) [1] was established in 2005 to promote reductions of greenhouse gas emissions in a cost-effective manner. More than half of the emissions covered by the EU ETS come from power generation, with industry making up most of the remainder. Carbon leakage is the term used to describe the situation that may occur if, for reasons of costs related to climate policies, certain businesses were to transfer production to other countries which take a less stringent (or no) action on greenhouse gas emissions, and if that would lead to an increase in global emissions (which could happen if the production that takes over is less greenhouse gas efficient).

To address the risk of carbon leakage for industrial installations covered by the EU ETS, free emission allowances have been given to industry between 2005-12 based on historical emissions, and are given to industry from 2013-2020 onwards based on harmonised benchmark based rules across the EU. Certain sectors covered by the EU ETS, deemed to be exposed to a significant risk of carbon leakage, receive a higher share of free allowances in 2013-2020.

In the context of the NER300 programme, the EU ETS provides over €2 billion for innovation through the demonstration of new technologies [2], and Member States should use auction revenues inter alia to finance energy efficiency and clean technologies in sectors covered by the EU ETS. Member States can also give compensation to certain industrial sectors in respect of increased costs for electricity due to the ETS, in accordance with State aid rules adopted in 2012 [3].

The Commission finds, in its policy framework for climate and energy in the period from 2020 to 2030[4],that as long as there are no comparable efforts undertaken in other major economies, similar policies (including an improved system of free allocation of allowances with a better focus) will also be needed after 2020 to ensure the competitiveness of Europe's energy-intensive industries. Besides a binding greenhouse gas emission reduction target, the 2030 framework also aims at achieving competitive and affordable energy prices, binding targets for renewable energy at the EU-level, promoting improvements in energy efficiency and a reform of the EU ETS. The greenhouse gas reduction rate of 40 % below the 1990 level should be reached by 2030 through continuous efforts by the ETS and non-ETS sectors in lowering their emissions. Moreover the proposed reform of the EU ETS includes the establishment of a market stability reserve at the beginning of the next trading period in 2021.

The purpose of the present stakeholder consultation is to canvass opinions on different options for a system to avoid carbon leakage after 2020 for sectors covered by EU ETS.

The results of this stakeholder consultation will feed into the further work on the 2030 climate and energy policy framework as concerns the determination of post-2020 rules on free allocation and carbon leakage provisions in the EU ETS. Furthermore, dedicated stakeholder meetings will be held in 2014 to enable more focussed discussions[5].

The questionnaire consists of 24 multiple choice questions and should not require more than 20 minutes of your time. There is room to motivate replies and respondents are strongly encouraged to justify their responses with references to concrete evidence and facts wherever possible. For each question it is possible to reply "I don't know/no opinion".

---

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32009L0029:EN:NOT
[2] http://ec.europa.eu/clima/policies/lowcarbon/ner300/index_en.htm
[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012XC0605(01):EN:NOT
[4] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014DC0015; http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014SC0015
[5] http://ec.europa.eu/clima/news/articles/news_2014041501_en.htm

Sandbag's Response to the Consultation

0. Registration

0.1 What is your profil?

- a) Business
- b) Trade association representing businesses
- c) Government institution/regulatory authority
- d) Academic/research institution
- **e) Non-governmental organisation**
- f) Citizen
- g) Other

0.2 Please enter the name of your business/organisation/association etc. (maximum 500 characters):

Sandbag Climate Campaign is a non-governmental organisation (NGO) that campaigns for effective carbon budgets and carbon markets, with a special focus on the EU Emissions Trading Scheme (ETS). If emissions trading can be implemented correctly, it has the potential to help affordably deliver the deep cuts in carbon emissions the world so badly needs to prevent the worst impacts of climate change.

0.3. Please enter your contact details (address, telephone, email):

Sandbag Climate Campaign is a not-for-profit enterprise registered as a Community Interest Company under UK Company Law. Company No. 6714443
Registered Address: BWB Secretarial Ltd, 2-6 Cannon Street, LONDON, EC4M 6YH
Trading Address: 28 Leman Street, Aldgate, London, E1 8ER
EU Transparency Register: 94944179052-82
Email : info@sandbag.org.uk
Web: www.sandbag.org.uk

0.4 If relevant, please state if the sector/industry you represent falls under the scope of EU ETS:

- a) yes
- **b) no**
- c) not relevant

0.5 The results of this stakeholder consultation will be published unless stated otherwise. Can we include your replies in the publication?

- **1) yes**
- 2) no

I. General: competitiveness, carbon leakage and present free allocation rules

The questions in this section are an opportunity for stakeholders to express their general and broader view on carbon leakage issues, the present rules on free allocation of allowances and will be useful from a policy evaluation perspective.

Question 1: Do you think that EU industry is able to further reduce greenhouse gas emissions towards 2020 and beyond, without reducing industrial production in the EU?

- **a) yes**
- b) no
- c) I don't know

If you wish, please motivate your answer (max. 1000 characters):

In each EU ETS sector, there are large differences in carbon intensity between different plants. This demonstrates that most plants are not using best available technologies and that industrial emissions could fall dramatically if they did. Innovation could increase the reduction potential even further. Attracting investment to Europe to recapitalise aging infrastructure is, however, a key challenge especially in markets where there is global competition. If the EU wishes to combine steep reductions in emissions with steady or ideally increasing industrial production it will have to ensure it has a holistic climate and industrial strategy and policy package that attracts investment.

Generous free allocations to industrial sectors to date have insulated them from a carbon price and offsetting has delivered a low carbon price overall. Though this has provided a way for companies to supplement their cash flow it appears to have failed to stimulate significant investment.

Question 2: Do you think that the EU ETS helps the EU industry to become more energy efficient, and thus contributes to increasing the competitiveness of European industry in the long-term?

- a) yes
- **b) no**
- c) I don't know

If you wish, please motivate your answer (max. 1000 characters):

In theory, increasing the cost of energy by internalising a carbon price increases investment in efficiency. However, through its allocation methodologies, the EU ETS currently creates incentives which reward reduced emissions irrespective of production levels. This means that even the most efficient installation is more rewarded by the scheme for reducing its production (by selling freely allocated spare EUAs) than for increasing it's output or keeping it constant. Those investing in genuine improvements in efficiency may find themselves disadvantaged relative to companies who choose to offshore production.

Question 3: Do you think the EU needs to provide special (transitional) measures to support EU industry covered by the EU ETS, in order to address potential competitiveness disadvantages vis-à-vis third countries with less ambitious climate policy?

a) yes

b) no

c) I don't know

If you wish, please motivate your answer (max. 1000 characters):

Industry covered by the ETS will in the future, as the cap tightens, face a choice between investing in emissions abatement or reducing production. There are many options available for reducing emissions by adopting 'best available technologies', however, companies need to feel confident in their position in the market to justify investment. The EU needs to develop a holistic long-term industrial strategy that seeks to commercialise low carbon technologies capable of replacing fossil fuel use in industry. Previous energy and climate packages have neglected this in favour of focusing on renewable technology support that has been successful in bringing about transformation in the power sector but failed to provide a decarbonisation pathway for industry.

Question 4: In your view, how adequate a policy instrument is free allocation and, in particular, increased free allocation for certain industrial sectors to address the risk of carbon leakage?

a) very adequate

b) quite adequate

c) quite inadequate

d) very inadequate

e) I don't know

If you wish, please motivate your answer (max. 1000 characters):

Free allocation is, in principle, an adequate means of protecting against carbon leakage; however, free allocation based on current rules (benchmarked against historical production fixed baseline years) is very inadequate to address the risk of carbon leakage.

Let's take the example of a firm owning two plants equally competitive, of which one is in the EU and is given free EUAs. The firm would make more profit from selling the EU plant's EUAs and producing the same goods at its (potentially more polluting) plant outside the EU, than from producing at the EU plant. This is carbon leakage in action.

Question 5: In your view, how does free allocation impact the incentives to innovate for reducing emissions?

- a) it absolutely keeps the incentive
- b) it largely keeps the incentive
- c) it largely compromises the incentive
- **d) it absolutely compromises the incentive**
- e) I don't know

If you wish, please motivate your answer (max. 1000 characters):

Free allocation is intended to cushion industry from having to pay the full carbon price for the emissions they are responsible for, however, it creates a perverse incentive to reduce emissions by reducing production, which is probably the least innovative solution to the problem. Company innovation is stimulated where there is confidence in securing a growing share of the market coupled with available capital to invest in R&D and deployment. Fears of reduced competitiveness and little or no reward for innovation undermine these conditions.

Question 6: In your view, is the administrative burden for companies to ensure the free allocation via the implementation of the benchmarking provisions proportionate to the objectives?

- a) absolutely proportionate
- b) quite proportionate
- c) quite exaggerated
- d) absolutely exaggerated
- **e) I don't know**

If you wish, please motivate your answer (max. 1000 characters):

As non-participants it is difficult to assess the administrative burden. In considering the potential additional administrative requirements of moving to a production based allocation methodology it should be noted that there is already a set of requirements relating to reduced production, which triggers reductions in allocations.

II. Options for post-2020

A. Strategic choices

Beyond 2020 the total number of allowances under the EU ETS issued per year will further decline. This makes the overall allowance budget available for auctioning and free allocation (the cap) each year gradually lower. At the same time, we expect increasing efforts by other major economic players in the context of the UNFCCC negotiations for a post-2020 agreement. Currently some 45% of the total number of allowances (the cap) is provided to industry for free in Phase 3 (2013-20).

Question 7: What share of the post-2020 allowance budget should be dedicated to carbon leakage and competitiveness purposes?

- a) a lower share than in 2013-20
- b) a higher share than in 2013-20
- c) a constant share as in 2013-20
- d) there should be no limit to overall free allocation to industry
- e) there should be no free allocation post-2020
- **f) I don't know**

If you wish, please motivate your answer (max. 1000 characters):

This is considering the issue from the wrong perspective. Rather than trying to second guess the level of free allocation required by industry the EU should consider policy changes that address (and possibly reverse) carbon leakage, by adjusting allocation to trade-exposed industries ex-post based on their latest (not historical) production levels. A benchmark could be set as the X% most efficient plants for each sector, so that any plant inside this X% would end up receiving more allowances than they need for each unit produced, while the rest would receive too few allowances.

For the avoidance of doubt, overall allocation should never exceed the cap, so that any increase in allocation due to increased production should be compensated by fewer auctioned allowances. This is made possible by the large number of allowances which are assigned for auction every year. If this number was to decline to zero (which could only happen in the event of an industrial production increase of about 100%), then no more allowances should be distributed.

With such an allocation method post-2020, if industrial production was low, allocation would be low, so the allowance budget dedicated to carbon leakage would probably be lower than in 2013-20. Conversely, if industrial production rose, allocation would rise and the allowance budget dedicated to carbon leakage would probably be higher than in 2013-20. Any loss of revenue to Member States arising from fewer auctioned allowances would be compensated for by more traditional tax receipts related to increased GDP.

Question 8: Currently the European Commission implements the NER300 programme to provide from EU ETS specific support for large-scale demonstration of Carbon Capture Storage (CCS) projects and innovative renewable energy. 300 million allowances, representing ca. 2% of total phase 3 allowances, are dedicated for this purpose. What share of the post-2020 allowance budget should be dedicated to such innovation support?

- a) a substantially higher share than in Phase 3
- b) the same share as in Phase 3
- c) a lower share than in Phase 3
- **d) there should be no such innovation support post-2020**
- e) I don't know

If you wish, please motivate your answer (max. 1000 characters):

This question is framed in too narrow a way. Support for innovation need not be limited to instruments that are created from within the ETS policy. Energy efficiency policies and renewables policies exist as separate policy instruments within the broader EU climate and energy package. Support for low carbon innovation in industrial sectors should be given a much higher profile and dedicated policies introduced that work alongside the ETS.

The NER 300 has dramatically underperformed relative to expectations due to the crash in EUA values in part caused by continued over-allocation to industry. A more holistic industrial support strategy working in tandem with the ETS would provide a higher degree of investor confidence.

Question 9: At the moment, EU ETS rules do not contain a specific support scheme for industrial innovation and deployment of new low-carbon technologies (apart from support for CCS and renewables under the NER300). Do you think there should be such a financial support scheme?

- a) yes
- **b) no**
- c) I don't know

If you wish, please motivate your answer (max. 1000 characters):

We support the introduction of dedicated policies to support deployment of non-renewable industrial low and zero carbon technologies. However it is too constraining to assume that innovation funding must be necessarily derived from the sale of ETS allowances. Allowance-based funding (as opposed to for example providing funding from public finances) introduces an unnecessarily uncertain method of raising finance which has proved to be unsuccessful to date.

Question 10: If innovative low carbon technologies in the industry are to be further supported, which could be possible sources of funding?

a) It should be funded under a system similar to NER300 with extended scope to cover greenhouse gases reduction technologies in the industry

b) It should be funded through a new dedicated scheme financed by the revenues from auctioning (e.g. x% of the auctioning revenues);

c) other types of funding (please specify)

d) I don't know

If you wish, please motivate your answer (max. 1000 characters):

If an output-based allocation method were in place within the cap, efficient industries could fund themselves by selling the excess allowances saved thanks to their low-carbon production. They can already do so of course, however, the cheapest form of abatement to date has been offsetting and reduced production which has distorted investment signals. If allocation were dynamic this would reward genuine gains in carbon efficiency.

Question 11: In your view, is there a need for additional measures beyond free allocation and EU-level innovation support to address the risk of carbon leakage for energy intensive sectors covered by the EU ETS, post-2020?

a) yes

b) no

c) I don't know

If you wish, please motivate your answer (max. 1000 characters):

There is a question of how to compensate rising costs due to higher energy bills where there are indirect emissions attracting a carbon price. The post 2020 carbon leakage policy should consider ways to harmonise compensation payments as a replacement for the current state aid provisions, which are subject to national variation.

II. Options for post-2020

B. Allocation modalities

There is a need for a more focused system of free allocation post-2020 because of the fact that the allowance budget post-2020 gradually shrinks. Providing innovation support would also require some headroom. There might also be a case for improving allocation modalities based on practical experience gained in developing and implementing the existing harmonised carbon leakage and free allocation rules.

Question 12: Currently there are two categories for sectors in terms of exposure to the risk of carbon leakage: sectors are either deemed to be exposed to such risk (the sectors on the carbon leakage list) or not (sectors not on the carbon leakage list). Should the system continue with two carbon leakage exposure groups or is some further differentiation needed?

- a) the present two groups should remain
- b) more carbon leakage categories should be defined
- c) there is no need for a carbon leakage list, all industrial installations should be treated as exposed
- d) there is no need for a carbon leakage list, all industrial installations should be treated as not exposed
- **e) I don't know**

If you wish, please motivate your answer (max. 1000 characters):

In practice virtually all sectors are qualifying and the concept of the binary list has therefore been devalued. There are also questions about the methodology used, which does not appear to be calibrated in a way to distinguish between highly exposed industries and those facing a more theoretical risk.

Question 13: Under the current system, exposure of sectors to the risk of carbon leakage is primarily measured by the share of 'carbon costs' in their gross value added (GVA) and by the intensity of trade with third countries. What carbon leakage criteria should be defined for the post-2020 period?

- a) the present criteria should remain
- b) only the share of 'carbon costs' in the GVA should be maintained
- c) the share of 'carbon costs' in the GVA should be maintained, but 'carbon costs' should be taken into account to the extent that they can't be recuperated in product prices
- d) only the intensity of trade with third countries should be maintained
- e) additional criteria should be defined (please specify which current criteria should be maintained and which additional criteria should be defined)
- f) both the current criteria should be replaced and other criteria should be used instead (please specify)
- **g) I don't know**

Question 14: What thresholds should be defined for the criteria measuring the risk of carbon leakage?

a) the present threshold (30% for the stand-alone criteria and lower values for the combination of several criteria) should be maintained

b) other thresholds should be defined. Please specify below

c) I don't know

Question 15: In the current system, there is a possibility to assess the exposure of sectors to the risk of carbon leakage also based on qualitative criteria (abatement potential, market characteristics and profit margins). Do you think that similar qualitative criteria should be maintained to complement the quantitative criteria?

a) yes, it is important to maintain a certain level of discretion in the system for justified cases

b) no, all criteria should be based on simple metrics and linked to clearly defined thresholds

c) I don't know

Question 16: Currently, the list of sectors exposed to the risk of carbon leakage is valid for five years. What should be the validity of the list for the post-2020?

a) five years

b) longer (please specify)

c) shorter (please specify)

d) in line with the duration of ETS Phase 4

e) I don't know

If you wish, please motivate your answer (max. 1000 characters):

No significant design elements of the ETS should persist for longer than 5 years, including the duration of Phase 4.

Question 17: Currently benchmarks are set to the average greenhouse gas emission performance of the 10% best performing installations in the EU for a given product. What adaptations of benchmarks for 2021 onwards should be considered, if any?

a) the present approach of average of the 10% most efficient installations should remain

b) the approach should be more stringent (please specify)

c) the approach should be less stringent (please specify)

d) I don't know

If you wish, please motivate your answer (max. 1000 characters):

The top 10% rule for assessment of *initial* allocations should remain, however, the existing benchmarking rules create very few 'winners' as ex ante assessments of need can easily be

rendered inaccurate solely through changes in production. An attempt to address this has been introduced through the use of production thresholds that, once passed, trigger reductions in allocations. Changes to the way in which such triggers work should be introduced to a) reward increases in production with ex post allocation of more allowances b) make the triggers for reductions in allowances more fine grained.

Question 18: Should the benchmarks be revised to reflect the technological state of the art?

- (●) **a) yes (please specify how often)**
- ( ) b) no
- ( ) c) I don't know

If you wish, please motivate your answer (max. 1000 characters):

Production-based allocation as described above should use benchmarks based on the X% most efficient plants, which will change as more efficient installations come on line. An updated benchmark level should follow the (likely increasing) efficiency of European plants.

Question 19: Currently, historical production data are used to determine the allocation due to each installation. Operators had the possibility to choose between 2005-2008 or 2009-2010 as basis years. Should the production data used to calculate allocations in Phase 4 (post 2020) be updated?

- ( ) a) no, the same baseline period chosen for allocation in Phase 3 should be maintained also for post 2020 (Phase 4) allocation
- ( ) b) yes, production levels in 2016-2018 should be the basis for post 2020 (Phase 4) allocation
- (●) **c) other (please specify)**
- ( ) d) I don't know

If you wish, please motivate your answer (max. 1000 characters):

Recent production data should be used to grant an initial allocation ex ante, and final allocation should be adjusted ex post according to actual production levels, as long as overall allocation never exceeds the cap.

Question 20: Is there a case for any deviations from general harmonised allocation rules, and what would be the risks involved?

- ( ) a) no, there should be no deviations
- ( ) b) yes, there should be deviations with higher allowances for installations facing specific hardships
- ( ) c) yes, there should be deviations with lower allowances for installations enjoying very favourable circumstances
- ( ) d) both b) and c)
- (●) **e) I don't know**

Question 21: Should there be a harmonised EU-wide compensation scheme for indirect costs, i.e. for increases in electricity costs resulting from the ETS?

a) no, the present approach should be maintained, i.e. that Member States can provide such compensation based on state aid guidelines

b) no, and there is no need for financial compensation by Member States, either

c) yes, in the form of additional free allocation

d) yes, in the form of financial compensation at EU-level

e) I don't know

If you wish, please motivate your answer (max. 1000 characters):

One way of harmonising compensation for indirect carbon costs would be to make additional allowances for indirect emissions available to energy intensive industries in an ex poste adjustment to initial benchmarked allocations. This would, however, significantly reduce the volume of allowances available to auction. This would not have any significant impact on price, however, it would reduce auction revenues to MSs, though doing so would reduce the pressure to provide compensation payments from the auction receipts as is already currently implemented in a number of countries. If such a system were introduced the state aid provisions for compensation for indirect costs would need to be removed.

A key test of whether such a change should be implemented is gaining support from industry for a significant reduction in the current surplus of allowances through cancellation, since they would then be insulated from the effects of any resulting price increases.

II. Options for post-2020

C. Innovation support

The transition to a low-carbon economy requires continuous innovation activities in many sectors and relatively long time and high level of investments to the final prototypes. The sectoral 2050 roadmaps have revealed some of the key technologies and innovations needed to master this transition. First movers in low-carbon innovation not only have the prospect of earning high returns on successful innovations, but also run the risk of failure. Hence support with public money might be justified, in particular for full scale demonstration projects, to complement other EU (and private) funding possibilities.

Question 22: In your view, at which stage of the innovation process is there a particular need to strengthen the EU's innovation support? Please rank the options from the most important to the least important.

	Most important	Important	Less important	Least important	I don't know
To implement a small-scale prototype	○	○	○	◉	○
At the conception stage	○	○	○	◉	○
To implement a large-scale pilot	◉	○	○	○	○
At the commercialisation stage	○	◉	○	○	○

If you wish, please motivate your answer (max. 1000 characters):

As most of the technologies needed for tackling climate change are already available, setting the right incentive to deploy these technologies should be the number one priority and this can be achieved best through aligning the incentives created in industry through allocation. Innovation support would still however be important for breakthrough technologies that will be needed to reduce emissions to nearly zero in all sectors by 2050.

If a 'promising' emission reduction technology was unable to attract private investments, public investment could be considered. The stage of development considered for public funds should then be the stage of development where private capital is missing for the technology.

Question 23: Should the allowances funding low-carbon innovation support come from the Member States' auction budgets or from free allocation?

- ○ a) from the Member States' auction budgets
- ○ b) from free allocation
- ○ c) from both
- ◉ **d) other**
- ○ e) I don't know

If you wish, please motivate your answer (max. 1000 characters):

As previously stated we support the introduction of dedicated policies to support deployment of non-renewable industrial low and zero carbon technologies. It is too constraining to assume that innovation funding must be necessarily derived from the ETS. Allowance based funding (as opposed to for example providing funding from public finances)

introduces an unnecessarily uncertain method of raising finance which has proved to be unsuccessful to date.

Section II:

D. Other issues

Question 24: Are there any other issues you would like to raise?

When considering climate policy for trade-exposed industries, the EU should not only think about the negative effect of carbon leakage but also the positive effect of the reverse phenomenon where it would become more attractive for a firm to efficiently produce in Europe than to produce less efficiently outside Europe. Such 'efficiency infiltration' (reversed carbon leakage) could be achieved by an allocation mechanism which would reward efficient plants for increasing, but never for reducing, their production.

Our responses to this consultation are made on the basis that we expect significant improvements to the ETS post 2020, including a significant reduction in the surplus of allowances that has accrued, and will continue to accrue this decade, and a challenging reduction target for the traded sector in 2030. We believe the power sector now has the potential to decarbonise at a relatively rapid rate but that insufficient attention has been paid to the need to stimulate genuine investment in abatement in the industrial sector. The ETS has thus far rewarded reduced production at the expense of longer-term investment strategies. The 2020 package failed to put in place sufficient technology support mechanisms to commercialise industrial decarbonisation. The 2030 climate and energy package must not make the same mistake.

ENDS