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## **EUROPIA Draft Position paper on the review process of the EU ETS directive**

### **Executive Summary**

The European Commission has started the process of reviewing the EU greenhouse gas emissions trading scheme (EU ETS) in the light of experience gained since the scheme began operating in January 2005. The changes will take effect at the start of the third trading period in 2013.

The European Petroleum Industry Association (EUROPIA) representing the refining industry (which contributed approx 3% of EU CO<sub>2</sub> emissions in 2005 and approx 7% of EU ETS sector CO<sub>2</sub> emissions) continues to broadly support the concept of emissions trading as a market-based instrument to minimise the cost of mandated reduction of greenhouse gas GHG emissions. The EU ETS is a first step towards an international scheme and its primary objectives should be to enable energy intensive industry and power generators to reduce their GHG emissions in the most cost effective way, and to stimulate emission-saving projects around the world.

EUROPIA wishes to express its support for the on-going review process as a vehicle to reflect and build on experience thus far and eventually improve the effectiveness of the scheme. EUROPIA remains, however, cautious about several material proposals that have been put forward. This paper details EUROPIA's position, views and recommendations on a number of specific issues.

### **1) The Scope of the EU ETS**

The inclusion of more sectors and more GHGs into the emissions trading market is desirable, as long as this genuinely provides more opportunities for reducing emissions at a lower cost and for stimulating innovation. This implies the availability of accurate and verifiable data but also of a number of different mechanisms to mitigate emissions. Industry can be made to fulfil these criteria whereas this is not the case for passenger road transport.

Carbon dioxide capture and storage (CCS) is a promising avenue for large scale GHG reduction. CCS projects must be allowed to generate credits in the scheme.

The scheme must ensure that similar installations/activities in different sectors are given equivalent treatment. In particular, unilateral inclusion of additional activities and gases in a Member State should only be permitted for activities which are specific to that State. Small installations could be allowed to opt out on the ground of disproportionate administrative costs provided that they are subject to other equivalent measures to curtail their emissions.

### **2) Robust Compliance and Enforcement**

Robust and uniform compliance and enforcement are essential for the credibility and proper functioning of the ETS. The availability of appropriate and fit-for-purpose Guidelines for consistent EU-wide monitoring, reporting and verification is critical in this respect, although giving such Guidelines the status of a Regulation would not bring additional benefits. A scheme for EU-wide accreditation of verifiers would be beneficial.

### **3) Further Harmonization and Increased Predictability**

An EU-wide cap would provide a more predictable framework while also giving an earlier signal than might be the case with national caps. This would generally be beneficial to the liquidity and stability of the market.

Definition of a long-term (15-20 years) environmental objective and of stable rules will be essential to create the appropriate incentive for investments in emission reduction technologies.

The petroleum industry, as a sector exposed to international competition, should continue to receive the bulk of its allocations free of charge until such time that worldwide carbon constraints have been imposed.

The petroleum industry's preferred option for allocation is full grandfathering as a simple and transparent system for which there is experience. As recognized in the current ETS Directive, there should be specific provisions to account for increases in GHG emissions resulting from other EU or national measures imposed upon the industry (e.g. product specifications, policy-induced demand changes etc).

Benchmarking based on performance parameters is also acceptable as long as it can be made to be transparent, equitable and practical. This is a particular challenge for petroleum refineries given the complexity and diversity of installations.

The petroleum industry opposes auctioning as it removes value from the businesses and damages its international competitiveness.

In the absence of full international agreements on GHG emission limitations, new entrants should be treated in a similar way to incumbents and continue to receive free allowances to safeguard the competitive investment position of EU industry.

### **4) Linking with Emissions Trading Schemes of Third Countries**

Linkage of the EU ETS with national and regional GHG emission trading schemes that are emerging in different parts of the world should in principle be supported since a larger carbon market will improve liquidity, opportunities to decrease CO<sub>2</sub> emissions and permit optimization of resources. Care should be taken, however, that the linking mechanisms remain workable and do not compromise the environmental objectives of anyone of the programmes, permit a net increase in overall emissions, or create competitive distortions.

Use of flexible mechanisms (Joint Implementation-JI, Clean Development Mechanisms-CDM and their successors post-2012) should not be constrained as they contribute to improving the cost-effectiveness of global GHG emission reductions and promote technology transfer. These mechanisms can also be used to provide an indirect link between emissions trading schemes with otherwise incompatible characteristics (e.g. intensity targets v. absolute cap).

Similarly the use of offsets projects should not be constrained as they broaden the scope of the system and provides an incentive for activities that may not have been influenced by the price of GHG emissions in the permit market.

## Supporting Rationale

### 1) The Scope of the EU ETS

#### *Expanding the EU ETS to other sectors and gases*

In principle, EUROPIA supports a wider emissions trading market as it provides more opportunities for reduction of emissions and lowers the overall cost. Subject to following criteria, a broad application would generally lead to a larger variety of reduction options, would be economically more efficient, create better market liquidity and create more opportunities for innovation.

However, the following criteria must be applied:

- Any sectors that are included must fit into the system of the "make-or-buy" model, i.e. that the holder of the allowances has both the ability to make reductions through specific projects to meet compliance or to generate length, or can buy allowances to meet compliance, i.e. the holder of allowances should be both the emitter and the party that can initiate projects that create reductions.
- Any extension to include other sectors and/or GHGs must be harmonized across the EU so as to avoid competitive distortions.
- Only activities/gases representing significant emissions should be included. Unnecessary bureaucracy and unreasonable costs should be avoided.
- New sectors/gases need to have standardised, cost-effective methods of measurement, allowing accurate and verifiable monitoring and reporting, and good quality baseline data.
- The impact of differences in abatement pricing needs to be taken into account.
- Generally, new sectors and/or GHGs should only be added to the scheme at the beginning of a new trading period.

#### *Sectors and gases to be included in the scope of the directive*

EUROPIA's opinion is that any enlargement of the emissions trading market to other sectors must be based on the above criteria, especially that any sectors/gases that are to be included must fit into the "make-or-buy" model. The allowance holder must also have a number of mechanisms available to mitigate emissions. If these mechanisms are not available for a particular sector, it is, in our view, inappropriate to include this sector.

- In an Industry ETS, this model stands up well. The allowance holder (e.g. refiner or power generator) can potentially switch fuels, can implement energy efficiency projects and can even change the mode of operation of the facility.
- However, Passenger Road Transport is not consistent with this model. The vehicle driver is the emitter and can be considered as the initiator of reductions (e.g. buying a new more efficient vehicle, driving differently or choosing a biofuel blends), however regulating at this point is currently impractical.

A balanced approach is required for managing transport emissions involving the fuel producers, the automobile manufacturers, local and national government and the consumer. Schemes that place the burden entirely with one party are unlikely to deliver the necessary reductions (especially in the case of road transport). Road transport schemes should operate separately from those established to manage greenhouse gas emissions from power plants and other large manufacturing facilities.

EUROPIA thinks that emissions should only be included in the EU ETS if they are measurable, or if they can be calculated in a verifiable way. Therefore, if monitoring and measurement requirements cannot be appropriate to a level that industry can meet, without entailing excessive costs, then these additional sources should not be included.

### ***Unilateral inclusion of additional activities and gases***

To avoid competitive distortions, unilateral opt-in should only be permitted for activities which are only found in one (or a few) Member States. In any case any opt-in should automatically apply to that activity wherever it is found.

### ***Streamlining the application of the current scope***

EUROPIA supports, as part of additional harmonization, the equal treatment of similar installations/activities in the different sectors to establish a level-playing-field and to avoid competitive distortions. For instance plants integrated into refineries and stand-alone plants (e.g. hydrogen manufacturing plants) should be treated in a similar fashion. Additionally, a common definition for combustion installations is necessary to harmonize the application of the current scope.

### ***Improving cost-effectiveness as regards small installations***

EUROPIA believes that emissions trading scheme is intended to enable emissions to be reduced at the lowest possible cost. However, the current rules include so many small emitters in the scheme, where monitoring/reporting/verification costs are disproportionately high, that this objective is not being fully met. It needs to be ensured that aforementioned costs at small installations are not disproportionate. Applying a suitable "cut-off-level" in absolute emissions would make the system more efficient. Excluded installations must however be subject to equivalent alternative policies and measures.

An alternative approach might be to reduce costs by applying "light-touch" monitoring and verification to the smallest installations.

### ***Carbon dioxide capture and geological storage activities***

EUROPIA welcomes the work the European Commission is currently undertaking to develop a proposal for a regulatory framework for CCS and looks forward to its publication later this year.

EUROPIA stresses the importance of explicitly recognizing in the EU ETS greenhouse gas emission reductions from carbon dioxide capture and storage (CCS) projects.

Decisions made on CCS for Phase 2 should be decoupled from those for Phase 3. For Phase 2 there may only be a very small number of CCS projects, most of which will be pilot/demonstration. These projects will be opted in by the respective Member State on a case-by-case basis. EUROPIA believes that the longer term structure of CCS is likely to differ from these initial projects and so that the case-by-case approaches of Phase 2 will not be robust enough to act as a binding precedent for Phase 3.

We propose that following the development of the draft CCS Directive it should be submitted to the relevant legislative bodies for rapid inclusion into European law. This should be enacted before 2012.

CCS projects will require high up front investment so EUROPIA expects that Government support will be necessary initially to enable such projects to climb the learning curve. The EU ETS and clean development mechanism (CDM) represent potential vehicles for delivering (part of) the necessary investment incentives.

### ***Emission reduction projects within the Community***

EUROPIA supports the inclusion of domestic offsets since it provide an incentive for activities that would not otherwise have been influenced by the price of GHG emissions in the permit market and bring lower cost abatement options to the system. However, it is important that there are no artificial limits placed in the system, which in the longer term can lead to market distortions or even market failure and thus counteract any incentivising effect.

## **2) Robust Compliance and Enforcement**

### ***Monitoring and reporting Guidelines (MRG)***

EUROPIA fully recognises the importance of monitoring, reporting and verification for the credibility and proper functioning of the emissions trading system. We therefore support robust compliance and enforcement and the creation of a reliable inventory to ensure the credibility of the EU ETS.

The ETS introduces a lot of new requirements with regard to monitoring, reporting and verification for which, authorities, operators and verifiers together have to go through the learning curve. It takes significant time to fully understand the implications of implementing the provisions of Commission Monitoring and Reporting guidelines (MRG). It is therefore important to make the MRG workable, allowing for flexibility and pragmatic /cost-efficient solutions.

Ultimately the aim is that the EU ETS will be linked with other emissions trading schemes worldwide. EUROPIA thinks that this will require all linked schemes to adopt comparable standards of monitoring and reporting. This will further reinforce the need to create pragmatic requirements.

As over-prescriptive MRG increase the administrative burden of the ETS on companies. Therefore, EUROPIA thinks that it should be ensured that the MRG do not contain any binding requirements that unduly onerous and burdensome for companies to comply.

An acceptable level of uncertainty should be arrived at taking into account the impact of the determination of total emissions and the costs associated with improvements.

In order to ensure EU-wide uniform standards of application starting from permitting and approval of monitoring plans, EUROPIA supports the consistent application of the MRG across Europe in order to create a level playing field.

EUROPIA is not in favour of the MRG being transformed into a Regulation since this in itself will not improve compliance and enforcement. Turning the Decision into a Regulation would be too prescriptive and would not solve the problem of non compliance and enforcement. It is essential, however, that the EU Commission and the MSs ensure the MRGs are enforced and applied equally across all Members States in order to preserve a level playing field and the fairness of the ETS.

EUROPIA is opposed to a more frequent (i.e. more than once per year) release of emissions data since this will increase the administrative burden for installations in the scheme and it is unlikely that

verifiers and regulators have the capacity to process more frequent reporting. Putting data, not properly verified, into the public domain could increase the risk of an undesirable market reaction.

### **Verification**

EUROPIA supports a more consistent application of the verification requirements across the EU in order to ensure a level playing field. Variability in the verification scope/assessment leads to distortions and therefore must be avoided.

The scope should only encompass the total emissions reported by the installation as well as the installation's conformance with the defined and approved monitoring methodology. The monitoring methodology should be decided by the Competent Authorities (CA) with possible significant impact on the verification findings in some cases.

EUROPIA supports the introduction of Community level accreditation for verifiers through national accreditation bodies.

A consistent approach regarding accreditation requirements and accrediting authorities across the EU will avoid market distortions.

EUROPIA is in favour of consistent application of compliance provisions across the EU and suggests that the Monitoring and reporting guidelines contain a clear definition of responsibilities between the different players (MSs, EC, and operator).

### **Registries**

EUROPIA believes that for the functioning of the EU ETS and its international credibility, and for the liquidity and efficiency of the market, it is vital that emissions trading infrastructure (registries/International Transaction Log) must be fully put in place.

EUROPIA suggests improving the CITL (Community International transaction log) database access enabling a complete annual database of EU ETS installations to be downloaded for further analysis, building confidence through transparency. EUROPIA also proposes allowing more than two representatives.

## **3) Further Harmonization and Increased Predictability**

### **Cap-Setting: EU-wide or national caps**

Setting the cap for the EU ETS at the EU- level could provide a more predictable framework that would be beneficial for the liquidity and stability of the market.

The EU ETS share of reduction within the 2020 target (EU: at least 20 %) should be carefully defined also taking into account the reductions to be made in other sectors.

### **Increased Predictability**

EUROPIA thinks that the EU ETS should be based on a long-term (15-20 years) environmental objective to create incentives for investment.

The extension of the allocation period may facilitate industry planning and optimise the cost – effectiveness of the system. In order to define the length of the allocation period correctly, the duration of the time required to deliver the investments must be also be considered.

The rules for the allocation period must remain stable overtime to promote the innovation and long term investment rather than the short term compliance.

### ***Allocation Methodologies***

EUROPIA suggested that the following elements should be taken into account when defining an allocation methodology:

- The price of carbon in itself provides an incentive for refiners to reduce emissions.
- EU refiners are exposed to international competition and would be at a significant disadvantage were they to pay for their carbon emissions.
- Efforts to reduce emissions in other sectors often result in increased emissions in refineries, e.g. as a result of more stringent specifications for transport fuels and shifts in demand.

#### **A. Allocations Free Of Charge**

**Industry sectors exposed to international competition should continue to receive the bulk of their allocations free of charge until there is a worldwide carbon valuation.**

EUROPIA continues to support the free of charge allocation in any of the periods of the scheme to limit the impact on competitiveness of the European industry. For ensuring a level playing field within the EU, and in order to limit distortion of competition within the internal market, there should be common rules on the basis of objective and non-discriminatory criteria.

Free of charge allocations such as Grandfathering or Benchmarking reduce the damage from international competitiveness in comparison with auctioning or sales.

As is already recognized in the current ETS, Directive the allocation methodology should include specific provisions allowing accounting for increases in GHG emissions resulting from other Community measures. The impact of these community measures may be direct as in the case of the manufacturing of ultra low sulphur motor fuels or indirect through market change impact: For instance motor fuels taxation differentiation and CO<sub>2</sub> emissions constraints on cars are likely to maintain diesel growth detrimental to gasoline consumption. The potential GHG impact of this demand imbalance has been estimated by Concawe in the report 1/07 to be published

This is key for the refiners, for whom additional environmental constraints will result in a substantial increase in energy-intensive equipment that implies additional CO<sub>2</sub> emissions. The Commission should take into account the so-called “Petroleum refining paradox” which implies that efforts to produce cleaner products for our customers, and therefore helping them to reduce their emissions, result in greater emissions inside the refineries.

#### **1. Grandfathering**

**The petroleum industry’s preferred option for allocation is full grandfathering as a simple and transparent system for which there is experience.**

Allowances should be granted free, based on the average historical emissions over a number of years (baseline period). Here, a larger number of years ensure that shutdowns and deviations from normal mode can properly be taken into account.

Therefore, EUROPIA supports full grandfathering as it is the most transparent procedure to establish a basis for allocation with verified references, particularly in the case of diverse and complex systems such as petroleum refineries.

In addition, both authorities and industry have gained valuable and extensive experience with the determination of emission inventories and allocation rules on which future systems can be built on. There is now sufficiently verified historical data to provide a credible and fair baseline period, long enough to reflect operational cycles.

Although it is sometimes viewed as a methodology that does not reward early movers or does not provide enough incentives for reducing emissions, these concerns do not apply to refineries as they have a vested interest in conserving energy

## 2. Benchmarking

**Benchmarking based on performance parameters is, in principle, a way of rewarding early action and good performance.** It should be at the same time transparent, equitable and practical, which is a challenge considering the complexity and diversity of petroleum refinery schemes.

In this respect, simplistic approaches based on e.g. CO<sub>2</sub> emissions per ton of crude would ignore this complexity and would hence be neither equitable, nor acceptable.

The downstream petroleum industry has the goal of establishing a benchmarking methodology applicable to refining, which the EU Commission may wish to consider. Until this goal is achieved the allocation methodology should continue to be based on grandfathering as a simple, practical, transparent and fair approach.

As happen with grandfathering, using a benchmarking mechanism an important amount of the allowances would be granted free of charge so the damage related with international competitiveness and the value removed from our businesses would be much lower than using other methodologies as auctioning.

All sectors have their own specificity so that separate benchmarking methodologies must be developed for each sector. Therefore, industry should have the lead in the development of its own performance-based benchmarking methodology as industry experience will be key to the success in this approach.

The issues related to emissions from power and co-generation units in various industrial sectors should also be resolved fairly.

Furthermore, the same sectoral methodology should be applied consistently across the EU, irrespective of whether caps are set nationally or EU-wide.

## B. Auctioning

**The refining industry opposes auctioning as it removes value from our businesses and damages our international competitiveness.**



Auctioning of allocations would add an additional burden on European Industry. The additional cost burden would increase international competitive distortions with countries which do not apply a carbon constraint such as ETS. The petroleum industry operates in an international market that curtails the ability of EU-based industry to pass on such region-specific costs to customers. Any transition to auctioning should be paced in accordance and contingent with an international agreement on carbon emission reduction.

Auctioning diverts resources which could be of greater value if used directly in implementing measures to reduce GHG emissions. Industry is better placed than governments to invest in GHG-efficient technologies and projects in the most economically effective manner.

Although it is sometimes viewed as simple and harmonized way of distributing carbon emission rights, auctioning is in effect akin to a carbon tax with the additional drawbacks that:

- The level of taxation is unpredictable,
- The burden selectively falls on sectors included in the ETS rather than the whole economy.

The use of auction proceeds is likely to re-introduce similar complexities to those associated with allocation methodologies.

The conduct of multiple auctions in the course of a continuous and free market has the potential to lead to price spikes and collapses.

Finally, the organisation and administration of auctions is a serious and complex undertaking that involves extensive commercial and financial expertise. Any mishaps could have deep implications for the EU industry covered by the ETS and could undermine the credibility of the whole scheme.

### ***New Entrants and closure of Installations***

EUROPIA is in favour of the principle that new entrants should be treated in a similar way to incumbents.

Sectors should contribute to the new entrant reserve (assuming the MSs use a two stage allocation methodology) in proportion to the expected demand that that sector will place on the new entrant reserve.

Governments should engage in the CO<sub>2</sub> market in order to balance the new entrants reserve (buy allowances in the market, in case of a shortage in the new entrant reserve, and sell allowances in case of a surplus).

EUROPIA agrees with the idea that new entrant and closure rules should mirror each other. However, any allowances already transferred to the registry should be retained by the installation.

## **4) Linking with emissions trading schemes of third countries**

A number of Domestic Emission Trading Schemes (RGG - northern USA, Canada, Australia NETS, California, Lieberman-McCain) are emerging with their own characteristics.

EUROPIA supports linking the EU ETS to other trading schemes as they develop in order to encourage the use of such market mechanisms all over the world and obtain a broader carbon market with its inherent benefits.

A larger carbon market will improve liquidity and opportunities to decrease the CO<sub>2</sub> emissions since more participants will provide more opportunities for low-cost abatement. A larger market may also increase the stability of the CO<sub>2</sub> price and at the same time optimize overall allocation of resources.

In general, EUROPIA supports policies that promote international cooperation and agreements to deal with this global issue. We would like to see as many countries as possible participating because it creates a level playing field and consistency in approach.

### ***Key elements of linking the EU ETS with third countries emissions trading schemes***

EUROPIA suggested that the following key elements should be taken into account for linking of the EU ETS with other trading schemes:

- The EU ETS linked with third countries should remain simple, workable and predictable in order to avoid difficulties in linking emissions trading systems, however some complexity could be acceptable if it served for purpose.
- All linked schemes should adopt comparable standards of monitoring and reporting so the requirements need to be pragmatic. In this regard, sectors and gases included in the linked schemes must allow for accurate and verifiable monitoring and reporting.
- The infrastructure needs to be fully functioning, i.e. all relevant registries should be workable.
- The linking of the EU ETS with other trading schemes does not compromise the environmental objectives of one of the programmes, permit a net increase in overall emission, or increase of competitive distortion.

### ***Linking the EU ETS to the flexible mechanisms (Joint Implementation-JI and Clean Development Mechanisms-CDM) of the Kyoto Protocol***

EUROPIA supports the use of flexible mechanisms (Joint Implementation-JI and Clean Development Mechanisms-CDM) as:

- They could contribute to the development of a global carbon price and allow the market to find the optimal path to global reductions in CO<sub>2</sub> emissions
- The projects could be also a way to transfer technology, improve local employment and improve local environmental conditions
- They are an example of transparent information that could provide us what happens on the back of market driven flows capital
- The use of these mechanisms already indirectly links global CO<sub>2</sub> markets and can continue to do so in case trading schemes can not be linked due to specific design elements.
- The origin of the emissions is not an important issue since the reduction of GHG emissions is a global problem. In this way the implementation of reduction projects can be promoted where their costs were lower.

In the post 2012 period, the role of the flexible mechanisms successors of the Kyoto project mechanisms JI/CDM would need to be reviewed since the demand for offset projects and credits can be expected to increase driven by future targets such as the 20% CO<sub>2</sub> reduction in 2020...

### ***Quantitative limits: pros and cons of caps and supplementary requirements***

In principle, EUROPIA thinks that the EU ETS should not be linked to schemes made on a non-regulatory basis such as voluntary agreements.

A comprehensive impact assessment for structural compatibility could be useful with these trading schemes that contain very different design elements in comparison with EU ETS (units, standards, stringency and type of targets, sectoral coverage, unilateral price cap, limits on the use of project mechanisms ...).

***Quantitative restrictions (gases, sectors and project types) on the use of offsets***

EUROPIA supports the use of offsets as they broaden the scope of the system and provides an incentive for activities that may not have been influenced by the price of GHG emissions in the permit market. They also could bring lower cost abatement options to the system. There should not be any limits imposed on the use of offsets since, in the longer term, any limit could lead to market distortions or even market failure and mitigate any incentivising effect.)

It is highly desirable that the approach to facilitating offsets projects be as consistent as possible with the emerging details of the Joint Implementation (JI) mechanism.

Regarding the improvement of the harmonization of the projects approval process, any rule must be clear, transparent and not open to interpretation.

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