



Towards an Increased Harmonization of European Emissions Trading

Position paper on the EU Emission Trading Scheme Review

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— Main recommendations

The establishment and operation of the European Union Emission Trading Scheme (EU ETS) has successfully created a truly European market for CO₂ allowances. The scientific and economic consensus on climate change has increasingly indicated that concerted emission reduction policies are required. E.ON believes that a shift to a low-carbon economy is possible and supports the further development and wider use of market-based mechanisms to achieve this change. A well-functioning EU ETS is the most efficient method to effectively incentivise companies to invest in the required cleaner technologies.

E.ON therefore welcomes the opportunity to take part in the Commission's consultation in preparation of a proposal to amend the legislative framework of emissions trading. The success of the European Union Emissions Trading Scheme is in our and all stakeholders' interests.

Based on the experience of the first trading period, E.ON believes that the EU ETS can be further improved to deliver long-term CO₂ abatement at lower cost. In a carbon constrained world avoiding all additional costs is not possible but it is imperative for international competitiveness, efficiency and fairness reasons that these are kept to a minimum. It is E.ON's view that the primary determinant of the level of the cost of carbon is the overall emissions reduction target set by political ambition. The EU ETS is the best instrument to ensure that these reduction targets are met at least cost.

However, the EU cannot combat global climate change on its own, since its share of global greenhouse gas (GHG) emissions is below 15% - other regions have to contribute to this environmental goal. Consequently a global market for CO₂ is needed. In addition, all sectors should contribute to the aim of CO₂ reduction.

E.ON believes that the development of the EU ETS post-2012 should be founded on three complementary and mutually reinforcing principles, namely efficiency, equity and credibility. Based on these principles E.ON developed recommendations for the continued improvement of the EU ETS. Of these, E.ON believes that the highest priority should be given to:

- **Consistency across Europe:** Comparable installations within the EU ETS have to be treated in a consistent manner across all member states regardless of geographical location, age or ownership. As a consequence, the cap for the sectors covered by the EU ETS, as well as the allocation rules should be set centrally, with the European Union as the geographic scope. Current treatment of installations under the EU ETS is a matter of national borderlines rather than embracing the concept of a single European internal market. This is inequitable and inefficient, as it creates competitive distortions.
- **Equity between new and existing installations:** The EU ETS should not lead to competitive distortions of the markets affected by the emissions trading. To ensure CO₂ abatement at least costs, entry and exit into these markets should not be prevented or stimulated by allocation rules, as this hinders the closure of inefficient installations and the

roll out of future abatement opportunities currently under rapid research and development.

- **Stable and predictable frameworks:** Investments in abatement technologies have long lead and payback times. Clarity on long-term reduction targets is needed to enable better price views on CO₂ and to value less carbon intensive technologies. Predictability of the EU ETS should be increased by greater transparency and clear communication of the long-term overall reduction targets for the sectors covered by the EU ETS. Rolling 20-year carbon emissions reduction targets, based on scientific consensus, should be set for ETS sectors by the EU. These long-term targets and the path to achieve them should then be clarified by trading periods which should have duration of at least 8 to 10 years. For short term efficiency of the system, actual emission data should be made more transparent.
- **Full access to domestic and global abatement options:** In order to achieve CO₂ abatement at lowest possible costs, all abatement options, including hydro, renewable, CCS and nuclear energy, should be leveraged to achieve CO₂ reductions. Emission reduction credits generated from project based mechanism like JI/CDM or domestic projects should be easily transferable into emission allowances valid under the EU ETS. The EU ETS should be linked to other regional GHG trading systems in order to develop a global market for the solution of a global problem. The abatement options of the sectors not included in the ETS should be reflected in a burden sharing between the EU ETS and non EU ETS sectors.
- **Move towards full auctioning of emission allowances:** E.ON believes that in long term, auctioning is likely to increase the efficiency, equity and credibility of the EU ETS, if it is applied consistently across Europe and for new and existing installations. The revenues should be used to reduce energy taxes. In general recycling of the revenues from auctioning should avoid competitive distortions and support the efficiency, equity and credibility of the system. Additional climate change policy instruments should also be removed for EU ETS participants, so that customers do not pay twice for CO₂ reduction. A transition from free allocation to full auctioning is recommended in order to allow operators to adapt to the impacts of the radical change towards a fully-auctioned system.

E.ON believes that the ideas and principles of market based approaches like the EU ETS should be used more widely to reach other policy aims.

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— E.ON's recommendations in detail

E.ON believes that a shift to a low-carbon European economy is possible but will require substantial investments. There is a clear requirement for strong and sustained incentives for companies to invest in new, cleaner technology. E.ON strongly favors the EU ETS as the most effective method to meet the GHG emission reduction targets and fully supports its continuation post 2012 - in the long run as part of a further international agreement with global goals for GHG emissions.

E.ON believes that the post-2012 EU Emissions Trading Scheme should be based on three fundamental principles: efficiency, equity and credibility. These principles are complementary and mutually reinforcing.

- **Efficiency**

Market mechanisms are the best means of meeting environmental targets at least cost. Efficiency requires a high degree of market liquidity, transparent information and the flexibility of mechanisms to adapt to changes in the supply/demand balance. Further, full access to all abatement opportunities unless costs outweigh benefits is needed.

- **Equity**

In order to achieve the long-term sustainability of the EU ETS, the EU ETS must be seen as being fair for all stakeholders. To ensure the equity of the EU ETS it is essential that the questions of burden sharing, distribution of wealth and international competitiveness are adequately addressed and resolved. Furthermore, consistency across member states and between installations is imperative.

- **Credibility**

As the EU ETS is essentially a market for property rights rather than goods and services it is essential that the scheme, like the monetary system, maintains its credibility. In order to give the required confidence for investment in carbon abatement technologies a stable, long-term framework must be set. Caps should necessitate real abatement and environmental delivery.

Recommendations on the scope of the Directive

E.ON believes that a wider scope of the Directive (2003/87/EC) would lead to the inclusion of more abatement opportunities and could possibly increase the efficiency of the EU ETS. However, a wider scope could lead to a less efficient trading system as expected efficiency gains have to be balanced against transaction costs. Where transaction, monitoring and verification costs are high the EU ETS is not the most efficient mechanism to reduce emissions. A wider scope could also endanger the credibility of the system. To maintain credibility, the integrity of the monitoring and reporting standards of the scheme is essential. The currently robust standards should not be sacrificed in order to increase the scope of the EU ETS.

As a default the EU ETS should be the preferred option for limiting greenhouse gases unless proven otherwise. Exclusion of installations or sectors from the scheme should only occur when it has been proven that the costs of inclusion outweigh the benefits to the scheme.

Based on these views, E.ON has developed the following recommendations:

- **Exclude small installations:** Based on the experience of Phase I of the EU ETS, E.ON recommends that small emitters (e.g. with CO₂ emissions below 25,000 t/a) should be considered for exclusion from the ETS. These installations contribute only to a small extent to the overall emission reduction, have relatively high monitoring and verification costs and are unlikely to increase trading activity in the market. For instance, E.ON's Heat division in Sweden has 45 installations covered by the EU ETS. A threshold of 25,000 t/a would reduce the number to 3 plants within the scheme but would still cover 94.5% of the 45 installations' CO₂ emissions.

For small installations, E.ON believes that other regulatory instruments are likely to be more effective and efficient in achieving CO₂ reductions. Their exclusion on the EU ETS would not have a detrimental impact on the scheme.

- **Include Carbon Capture and Storage:** E.ON believes that carbon capture and storage (CCS) technology has the potential to play an important role in future CO₂ reductions. For these abatement opportunities to be realized it is essential that the EU ETS does not distort incentives to use CCS through the allocation system. This means that the differential in emissions of CCS plant compared to conventional fossil fuel plant must be reflected in the investment decision. If the allocation method of the EU ETS is auctioning this will automatically be the case. Where there is a free allocation, CCS should not be disincentivised compared to other fossil generation.
- **Include projects within the Community:** E.ON is in favor of investigating further how to include "domestic" emission reduction project credits in the EU ETS. These projects provide a route for other sectors and gases to play a role in the EU ETS. Again this is subject to the caveats that the credibility of the scheme must be maintained and the environmental delivery ensured. Any burden sharing agreement risks distorting the impact of domestic projects on the emissions trading market and increases the risk of double counting.
- **Expansion to other sectors but only when credibility can be ensured:** In E.ON's opinion the inclusion of most other sectors is at present not the best method to reduce emissions at least cost. For example, an installation based approach would not be feasible in the residential and commercial sectors, due to the small CO₂ emissions per emitter. An upstream approach where the energy supplier has to trade emission allowances based on the customer's emissions would contradict the "polluter pays" principle, as the supplier has no control on customer's CO₂ emissions. The price inelasticity in this sector will not give a sufficient incentive to reduce CO₂ emissions. E.ON therefore recommends exploring options such as project-based mechanisms within the EU to link these sectors to the EU ETS.

- **Expansion to other gases but only when credibility can be ensured:** For next phase E.ON views it unlikely that the inclusion of additional greenhouse gases can be achieved without significant costs to maintain the strict monitoring and reporting which guarantees the reliability of the EU ETS. The heterogeneous global warming potential of these gases will most likely increase the uncertainty of the system. This view is supported by the ECCP review on non-CO₂ greenhouse gases. Over time the costs of inclusion might decrease. An inclusion into the EU ETS should be revisited prior to each trading phase starting. In the meantime, E.ON recommends exploring the option of a project-based link between these gases and the EU ETS to provide an incentive to reduce emissions.

In addition the current scope of the directive should be applied consistently across Europe:

- **Installation definition:** The definition of a combustion installation under the EU ETS should be harmonized on an EU-level. The current national interpretation leads to market distortions and does not create a level playing field in Europe.
- **Unilateral inclusion of additional activities and gases:** E.ON also recommends restricting the leeway of member states to unilaterally include additional activities and gases in the EU ETS in order to avoid competitive distortions between different member states.

Recommendations on further harmonization and increased predictability

As the EU ETS creates a European market and affects European commodity markets, further European harmonization is needed to be compatible with the idea of a European internal market. Further predictability of the framework is needed to improve the credibility of the EU ETS. This is required because the value of the CO₂ allowances traded within the EU ETS is only based on the credibility of the reduction target and the overall system.

E.ON has developed the following recommendations in order to increase the harmonization and predictability of the system:

- **Ensure consistency across member states:** E.ON recommends a centralized approach to the allocation of the allowances, which uses the EU as the unit of geographic scope. E.ON believes that comparable installations should be treated similarly regardless of geographical location, age or ownership and a centralized EU authority will greatly aid the achievement of this, as discussed later. Therefore on the EU level, a cap for the trading and the non-trading sectors has to be agreed. For the non-trading sectors, a burden sharing between member states could be achieved. For the trading sector one European cap is recommended, as this increases the efficiency and equity of the EU ETS.

Consistent treatment of comparable installations within the EU ETS across all member states is essential, as the EU ETS is a pan-European system. Current treatment is a matter of national borderlines rather than embracing the concept of a single European internal market. For instance, with a system of one NAP per member state a new installation could currently have 27 different allocation volumes depending on the country in which it is built. This can be seen as inequitable and also creates unnecessary invest-

ment distortions that mean the environmental target will not be met at least cost. Furthermore it is in conflict with the aim of creating a single common market.

- **Ensure equity between new and existing installations:** E.ON recommends equivalent treatment of new and existing installations, as only this ensures CO₂ abatement at least costs. It is essential that the closure rules relating to the allocation of any free allowances do not result in incumbent installations remaining operational longer than it would have been without emissions trading. This barrier to exit effectively creates over-capacity which in turn prevents the emergence of new, cleaner installations.

Equally, a preferential treatment of new installations has to be avoided. This would lead to too early and too fast replacement of the existing installations and would restrict the access to future abatement opportunities currently under rapid research and development.

- **Set up stable and predictable frameworks:** E.ON believes that transparency and clear communication of the long-term overall reduction targets for the sectors covered by the EU ETS could help to increase the predictability of the overall system. It is recommended that a regularly updated rolling 20-year carbon emissions reduction target, based on the latest scientific expertise, should be set by the EU. These long-term targets and the path to achieve them should then be clarified by trading periods which should have duration of at least 8 to 10 years. To facilitate investments in low carbon technologies needed for meeting the climate change target, a stable framework for the EU ETS is necessary. Investors need a predictable EU ETS to manage the risk of their investments related to long lead and payback times.
- **Ensure equity between sectors:** Sectors where global competitiveness is a critical issue may in exceptional cases require a different allocation methodology in order to maintain the credibility and fairness of the EU ETS. In these globally competitive sectors emissions might simply be exported to non-carbon constrained economies by a relocation of production. Given that greenhouse gases are a global problem it is crucial that environmental delivery is real and that emissions should not simply be displaced. This reality could be taken into account in the determination of the allocation methodology and other EU ETS rules.

E.ON believes that an EU-wide harmonized and comprehensive auctioning could increase the efficiency, equity and credibility of the EU ETS. However, if auctioning is applied inconsistently between member states, new and existing installations or between comparable activities it would lead to competitive distortions. This is likely to risk the current achievements of reaching an internal European market. Furthermore, auctioning would only be feasible if the trading rules and the CO₂ reduction path are predictable. E.ON therefore recommends a stepwise move towards full auctioning together with European harmonization, equity between new and existing installations and increased predictability. E.ON recommends exploring the distributive effects of auctioning before deciding on the recycling of revenues. The recycling of the funds should avoid competitive distortions and support the efficiency, equity and credibility of the system.

Recommendations on robust compliance and enforcement

Robust compliance and enforcement procedures and transparency on the achieved CO₂ reductions are essential to maintaining the credibility of the EU ETS. However, based on the experience of the first trading periods, E.ON believes that more transparency and more harmonization of monitoring, reporting and verifying is needed.

E.ON has developed the following recommendations:

- **Development and application of harmonized standards:** E.ON encourages the development and application of harmonized EU standards for monitoring and reporting.
- **Reduction of the administrative burden where possible:** The administrative burden should be reduced without leading to a loss of rigor. For smaller companies it might be more appropriate to use measures other than the EU ETS to reduce emissions from smaller installations. Alternatively, the Commission should explore options such as removing the requirement for small plants to have annual independent verification even when no changes have been made to the installation.
- **Increase transparency:** To establish a functioning market for emission allowances, transparency is of utmost importance: Data should be announced to the market in a coordinated way, as already done in financial markets. A regular update of emission data e.g. monthly or quarterly is recommended. How the burden of these regular updates could be minimized should be explored, e.g. by using non verified internal data or only by verifying the monitoring and reporting methods.

Recommendations on linking

Climate change is a global challenge that necessitates a global solution. GHG emission reduction projects wherever they are located increase the range of abatement possibilities and thus raise the ecological efficiency of the trading system. Whilst the EU's stated unilateral emission reduction target is helpful for investment certainty E.ON believes that project-based mechanisms and emissions trading schemes that provide a link to outside of the European Union could deliver a valuable contribution to meeting the climate change challenge. Furthermore, a global approach helps create a global price/cost of carbon.

E.ON therefore recommends to

- link the EU ETS, whilst maintaining its credibility, with other GHG emissions trading schemes, such as the nascent US Regional Greenhouse Gas initiative, the Californian and Japanese schemes;
- include credits from JI/CDM projects and Green Investment Schemes (GIS) backed by real emission reduction efforts;
- investigate and implement the mechanisms to include credits from "domestic", i.e. Community, GHG emission reduction projects.

E.ON is aware of the ongoing debate concerning the real environmental delivery of some project-based schemes and the consequent effect on the credibility of the EU ETS. However, we believe that, subject to comparable market rules including monitoring and verification requirements and the problem of double-counting being addressed, project-based credits should be fully and easily fungible with EU ETS allowances. It should be borne in mind that after 2012 it may not be that easy to harvest abatement opportunities as these have already been exploited by non-EU ETS countries.

Should complementarity continue as a concept post-2012 and thus EU-based abatement is preferred, a pragmatic approach could be that up to 50% of the EU ETS reduction efforts should be permitted to come from JI/CDM projects or non-EU ETS trading schemes. Clearly, as "domestic" projects are within the EU there should be no limit on their use for compliance and hence they should be excluded from any complementarity calculation.

Should any "quota" be set for the EU for the use of non-EU credits, it is essential that there is no limit on their use at an installation level. This will allow the use of such credits to be used in the most efficient manner in the EU ETS and further demonstrate their fungibility. These credits should not be treated as being of secondary status.

Recommendations on institutional and procedural aspects

E.ON recommends a centralization of EU ETS target setting and allocation rules. Currently the system of member states developing national allocation plans results in the opportunity for the political agenda to interfere with environmental and market requirements. Given the international nature of climate change E.ON believes a central EU body can perform the required tasks more effectively and efficiently than member states. Within an agreed political framework, E.ON believes that a centralized European competent authority should be set up to determine and implement:

- the allocation methodology
- market rules, for instance, monitoring and reporting requirements
- the degree of linking with other mechanisms

Such an authority would enhance the credibility of the scheme through reducing the degree of political risk in the target setting and allocation process by translating politically set objectives into concrete targets. Importantly, more accurate forecasts of emissions could be expected as bias from vested national interests would be diluted. A harmonized European approach guided by a central authority would also aid the efficiency and perceived fairness of the system.

Recommendations on the relationship with other market based instruments

In addition to the EU ETS several other mechanisms are used across member states to tackle climate change, for example, the climate change levy in the UK, specific renewable and CHP systems in UK or Germany. Given the aim of meeting our ambitious climate change targets

at least cost wherever possible, double taxation and additional regulatory approval for EU ETS participants should be avoided.

As previously stated, the EU ETS should be the default preferred option for combating climate change in the EU. E.ON agrees with the idea that sectors covered by the EU ETS could be excluded from parts of the Energy Taxation Directive, as it is suggested by the recently published EU Green Paper on the use of market-based instruments for environment and energy related policy purposes. More widely, participants in the scheme should not be subject to additional climate related regulation. Furthermore, the scheme should not be used to deliver any additional policy objectives other than meeting the climate change targets - other policy objectives need other mechanisms.

Where climate change related policy instruments exist in duplication to coverage by the EU ETS there should be a defined transition period towards an exclusive coverage by the EU ETS. For Germany this would mean the end of double subsidization of CHP via a preferable allocation under the EU ETS and the parallel grant of subsidies by the government. In the long-run, feed-in tariffs for renewables are also incompatible with the EU ETS since power from such sources should in itself be economic in the EU ETS. In Sweden, the electricity certificate system is planned to be phased out in 2030. After this period, renewables should be competitive without the certificate system due to the burden on fossil-fuel plants within the EU ETS. Currently some Swedish installations within the EU ETS are paying a CO₂ tax which should be removed in order to get a level playing field.

Conclusions

E.ON is firmly committed to supporting market-based mechanisms and considers the EU ETS as central to meeting the EU's long-term carbon reduction targets. We believe that our recommendations will enhance the efficiency, equity and credibility of the EU ETS to create a scheme that will provide an example of best practice for other emissions trading schemes globally.