

**Final Report of the 3<sup>rd</sup> meeting  
of the ECCP working group on emissions trading  
on the review of the EU ETS**

on

***Further Harmonisation and Increased Predictability***

21 – 22 May 2007

**Centre Borchette, Rue Froissart 36, 1040 Brussels**

**Agenda Item 0: Welcome and Introduction**

The chairman, Mr Jos Delbeke (European Commission) welcomed participants and highlighted the importance of the meeting. He also appreciated having a balanced list of speakers and presentations on the agenda of the meeting.

**Agenda Item 1: Cap-setting: EU-wide versus national caps**

In his presentation, Mr *Felix Matthes* (Öko-Institut) identified four general options to define the split of an EU-wide cap between the ETS and non-ETS sector:

1. Efficiency approach
2. Equal burden approach
3. Grandfathering approach
4. Equity based approach

He said that in order to avoid distortions in the internal market and to ensure compliance with the EU cap, a harmonised approach would be necessary and appropriate. National ETS caps can be based on a common approach in the framework of an EU cap. A flat rate reduction differentiated by ETS sectors where EU benchmarks could be applied would deliver the caps. Assuming certain reduction targets, the caps for the traded and non-traded sectors would be defined.

Mr Matthes concluded that if MS were to take on separate commitments under the international regime, national caps are very likely. However, an EU-wide common approach differentiated by ETS activities would be necessary, appropriate and feasible. Analysis showed that sufficiently robust and precise criteria for national caps based on EU-wide methodology could be formulated.

According to Mr *Christian Egenhofer* (CEPS), cap-setting and allocation under the current EU ETS has been a highly decentralized negotiation process, characterized by the principle of subsidiarity, industry preferences and reflecting the material differences of Member States. It entails costs, which occurred due to a number of various reasons.

With a view to avoiding distortions on the internal market and preserving environmental effectiveness at the macro level, cap setting could either be done through emission projections or an emissions coefficient applied to MS, sectors and

installations. At the micro level, allocation would be laid down by EU rules and implemented by the Commission, or, as currently, by Member States.

Against this background, he identified two options with the EU ETS sector treated as if it were a Member State:

- Cap-setting and allocation applied by EU based on agreed methodology;
- Cap-setting by EU and allocation by Member States with variations concerning the treatment of new entrants.

Mr Egenhofer concluded by saying that

- agreeing on “objective” methodology for emissions projections is doable
- agreeing on an “objective” emissions co-efficient (e.g. benchmark) for MS, sector, installation is the challenge
- principal distortions are due to EU-based burden-sharing agreement (better BSA needed for Member States or for ETS sector)
- A key consideration is the application of a Community co-efficient (or benchmark) for cap-setting (politically feasible if combined with special pleading).

Mr ***Stefan Moser*** (European Commission) considered the advantages and drawbacks of upfront or NAP-based cap setting. He noted that upfront cap setting would lead to a modification of the current system and would mean that the distribution of the reduction burden between the EU ETS-sectors and the non-EU ETS sectors would be dealt with in a harmonised manner across Member States. This could be achieved through separate national caps or an EU-wide cap.

While a number of advantages would emerge from an up-front cap-setting, one consequence of an up-front cap-setting would be less flexibility and margin of discretion for Member State authorities to differ allocations from those in other Member States.

Mr Moser concluded that more harmonisation of cap-setting procedures can reduce regulatory uncertainty and can improve simplicity, fairness and predictability for both operators and the market. A more harmonised approach can reduce distortions of competition and of the internal market as well as volatility of allowance prices.

Ms ***Kate Hampton*** (ECIS) presented the perspectives from the financial market’s point of view. While business would not need complete certainty, it would need confidence in the predictability of policy, which from the business point of view means de-politicisation. In the current system, she considers that too much political/policy risk exists.

The national allocation process provides an additional and unnecessary layer of policy uncertainty and should therefore be removed. An EU-wide system of auctioning and benchmarking should support the EU-wide cap to be set out to 2020, with additional visibility to 2030 as soon as possible. According to Ms Hampton, the cap should be based on a formula that is a function of the EU 20% and 30% targets. Such a cap would be simple and transparent and would provide greatest predictability. It should

be committed to, even before an international agreement is reached, so that businesses can make their own risk assessment of the caps. Optimally, the formula would be included in the Directive. As a minimum, the cap should be a reduction by the trading sector that is proportional to its emissions. However, marginal abatement cost (MAC) analysis suggests that the trading sector should go deeper.

### **Discussions:**

In the debate, the Chairman highlighted the need to de-politicise the EU ETS. None of the stakeholders present questioned the need for further harmonisation of cap setting. Almost all stakeholders supported a more harmonised cap-setting approach, thus illustrating a very broad consensus to improve cap setting. Some Member States considered harmonisation closely associated with a level playing field, while other stakeholders pointed to the international dimension of the EU ETS. In their view, more harmonisation would fit well in the international discussion on sector approaches and could convey a signal to bring in developing countries. Furthermore, the goal of compatibility between the EU ETS and the international level in technical terms was stressed, in order to internationally recognise emission reductions achieved by the EU ETS.

Albeit not against more harmonisation, some Member States consider it important to take into account specific national circumstances, such as the level of economic development, impact on economic growth, but also how the energy intensive or export dependent industry would be affected. For these reasons, in their view harmonisation should enable a certain degree of flexibility.

Representatives of several Member States, power generators, carbon traders and NGOs advocated an EU-wide cap for a number of reasons: it is considered best to deliver in terms of clarity of targets, a harmonised level of ambition and future scarcity of allowances. It could best ensure a level playing field and would take away the discretion of Member States resulting in adverse and distorting effects. Representatives of the carbon trading sector and NGOs argued it would also lead to a higher level of transparency, which would make the EU ETS more comprehensible to the outside world and underpin the political leadership of the EU.

Issues raised in the context of an EU-wide cap concerned the determination of such a cap, its impact on sector caps and economic development and growth.

### **Conclusions:**

Following the debate, the Chairman concluded 5 points:

There is a unanimous call for improved cap setting. In terms of environmental effectiveness, NAP1 did not deliver and NAP2 required firm intervention by the Commission. A systematic approach is now needed, also in the light of the international dimension, for the sake of which the EU has to be able to explain in clear terms how cap-setting works.

There is a general, very strong message calling for more harmonisation, if not a centralized EU cap. This raises questions on how to do it including considering the EU ETS as if it were a separate Member State. Cap setting has to be in line with the firm decision of the Heads of State and Governments to reduce overall greenhouse gas emissions by at least 20% by 2020, increasing to 30% under certain conditions.

There is a need for strong separation between cap setting and allocation to keep the process politically and technically manageable.

There is a strong call for transparency for both cap setting and allocation. A level playing field and the recognition of regional circumstances and the diversity of the EU emerge as the principles and criteria to be applied for cap setting. Both may appear from further detailed work on sector allocation processes.

There is a very strong call on predictability meaning the 3<sup>rd</sup> trading period to last at least until 2020. All stakeholders called on longer periods, no one spoke in favour of a 5-year period.

## **Agenda Item 2: Increased predictability**

### **Presentations**

Mr **Franzjosef Schafhausen** (Germany) made a presentation on increased predictability. In his view, predictability would be assured by:

- determining the rules and formula for cap-setting up-front in the ETS directive;
- linking the total ETS cap to the 20/30% target and the result of the burden sharing process;
- establishing indicative targets for the time beyond 2020;
- determining clear and harmonised allocation rules for all sectors as well as incumbents and new entrants in the Directive.

In his presentation on “Increased Predictability in Emissions Trading”, Mr **Owen Wilson** (Eurelectric) proposed that in order to increase predictability, the revision of the Directive should focus on:

- Stability in rules determining the ETS cap;
- Stability in rules determining the allocation trajectory;
- Well-signalled changes in the methodology of allocation;
- Either no restrictions on companies' use of JI/CDM, or, restrictions linked to targets;
- Well-signalled direction on energy R&D and technology support schemes;
- Known conditions/principles for linkage to other schemes;
- Well-signalled changes in percentage auctioning, coordination of auctioning;
- Opportunity to comment on future developments.

Mr **Mark C. Lewis** (Deutsche Bank) presented ideas on improving the predictability of the scheme. He concluded that medium-term compliance periods within a long-term emissions trajectory is the rational policy for the following reasons:

- A long-term cap set only for 30-40 years in the future would greatly reduce the incentive to change behaviour in the short term, as economic agents would hope for improved technology later in the period, or find other excuses to delay adaptation
- However, having a long-term trajectory (30-40 years) for the carbon cap with shorter-term compliance periods (8-10 years each) should ensure that the behaviour of the agents covered by the scheme take the long-term trajectory into account from the outset of the first compliance period

### **Discussions:**

The debate confirmed that a stable framework of rules and principles on cap-setting, the split between the trading and non-trading sector and the trajectory would be the most important elements for increased predictability. These elements have also to be seen against the background of the international regime, to which the EU ETS should fit, however, without being dependent upon this. Representatives of Member States and the research community highlighted the role of allocation methods for the length of trading periods, also in terms of the carbon price signal. A representative of the power generation industry suggested that a predictability period should be envisaged, which is longer than the allocation and compliance period, but shorter than the cap period.

In the view of the research Community, a 5-year trading period could be justified only because of the uncertainties of the international regime, while others considered a 8-year period not too long and often too short in the light of the lead time for investments. 10 years might be a reasonable timeframe for representatives of the carbon trading sector.

Some industry representatives took the view that banking and borrowing of allowances would enable there to be short trading periods, but would also provide some flexibility to introduce new technologies. Representatives from the carbon trading sector raised concerns about borrowing across compliance periods, while representatives from the financial sector and NGOs are against borrowing, as this would detract from the purpose of having shorter compliance periods.

### **Conclusions:**

Following the debate, the Chairman concluded two points:

1. On the basis of the arguments put forward, there seem to be a consensus emerging to align with the period on which a firm political decision has been taken, i.e. the 3<sup>rd</sup> trading period to run from 2013 to 2020. The debate has confirmed the importance of having a longer perspective, for which a political orientation indicating a reduction target of 60 to 80% by 2050 is becoming clearer.
2. Stable and reliable rules of the game are very important and for this reason, a too frequent revision of the EU ETS, e.g. in 2014/15 should not be envisaged. There are, however two caveats in this respect: first, the revision of the international regime, which could lead to more ambitious targets, and second, linkage with other emission trading regimes, which will have to be based on an explicit decision-making process.

### Agenda item 3: Allocation methodologies

#### Presentations

Mr **David Harrison** (NERA) presented an overview of allocation methodologies and principles. He identified environmental integrity, efficiency and distributional effects as major evaluation criteria. Harmonisation should be pursued in line with the following principles:

- Harmonisation is more important where non-harmonisation increases compliance costs or inefficiencies
- Non-harmonised new entrant allocations raise efficiency concerns
- Non-harmonised auction shares and incumbent allocations affect efficiency less, and may result in possible distortion of the internal market
- Some non-harmonised parameters give rise to “prisoners’ dilemma” and Member States may find it difficult to change unilaterally and thus should prefer harmonisation.

On behalf of IFIEC Europe, Mr **Vianney Schyns** (IFIEC Europe) presented ideas on “Improving allocation – Performance based allocation is feasible...”. From his point of view, auctioning would raise serious concerns with respect to competitiveness, leakage and recycling of revenues and would not be appropriate to solve the problem of windfall profits in the electricity industry.

However, benchmarking may offer a solution, as with suitable benchmark formula, it would bring about the same incentive for low carbon technologies as auctioning. In his view, the incentive derived from benchmarks to reduce emissions would be independent of the exact value of the benchmark in a certain year. Finally, performance-based benchmarking would provide incentives along the whole product chain and would also accelerate transition to a global trading scheme.

Mr **Alistair Steel** (EuroChlor) presented energy issues on behalf of EuroChlor. Due to electricity accounting for more than 50% of full production costs in the chlor industry, compensation for the energy intensive industry in the form of free-of-charge allowances taken from electricity generators must in his view be accepted as a legitimate concept. Benchmarking, however, is acceptable to the chlor industry while auctioning is not, but if it was to be adopted, the revenue arising should be recycled.

On behalf of CEFIC, Mr **Peter Botschek** presented “Solutions for an improved ETS”, which in his view, are mainly necessary to ensure competitiveness of the chemical industry. He proposed the targeted introduction of performance-based allocation through benchmarks to large emitting, homogenous processes, linking allocation to production and excluding small emitters from the EU ETS.

Auctioning would exacerbate the problem presented, although theoretically auctioning of allowances would be an ideal way of allowance allocation if applied world-wide. Recycling of auctioning revenues could lead to additional administrative procedures and costs, while a level playing field could not be ensured if there were different practices in different Member States.

Mr *Yves de Lespinay* from the European Lime Association presented a “Global Lime Carbon Allocation Model” for the post 2012 carbon allocation based on the development of benchmarks. While work on the model is currently ongoing, a draft of it should be available in September 2007 and the full model by the end of 2007.

According to Mr *Jean-Marie Chandelle* (CEMBUREAU), criteria for benchmarking in the European cement industry should be performance based on historical specific emissions. While opposed to auctioning, revenues gained from auctioning should be used to reward the best performance. Mr Chandelle also presented a global sectoral approach for CO<sub>2</sub> reduction in the cement industry. He concluded that the concept can be integrated in the logic of national or regional schemes, and allows a worldwide vision in the cement sector and a progressive evolution of non-constrained developing countries into a common scheme.

Mr *Marco Mensink* (CEPI) presented views on improving allocation of the EU pulp and paper industry. He stressed that the large number of installations, the large variety between installations and large number of smaller installations would create a challenge to implement benchmarks in the pulp and paper sector. Current benchmarks in member states (NL, BE, AU, Germany) are not fit yet to be brought directly to the EU level.

Mr Mensink advocated a combination of benchmarks and grandfathering for various reasons. Auctioning would only give limited possibilities of recycling revenues and without return of revenues, auctioning of credits would take away the funds needed to make technical progress and directly influence global competitiveness.

Mr *Guy Tackels* (CPIV) made a presentation on the allocation method in the glass industry. In order to improve the allocation method, fine-tuning by glass sub-sectors would be absolutely necessary and free allocation would be essential (on the basis of world-wide competition). Auctioning should be avoided. The allocation method must take into account unforeseeable production growth and the wide diversity of the Glass industry. A sector-related method and benchmarking is worth considering, but admittedly quite complicated. For this reason, auditing can be used as a safety net. A harmonised European benchmark is required.

Mr *Kevin Farrell* (CERAME-UNIE) presented “Key positions of the European Ceramics Industry on ETS and allocation methods”. Under certain conditions, benchmarking could be applied to the ceramic industry. In Mr Farrell’s view, auctioning is not adapted to the ceramics industry and should be avoided, as it is perceived as favouring carbon price volatility and is very likely to deter new investments in the ceramics sector. However, should auctioning occur, the revenues from it shall be recycled to those industries that have no possibility to pass on cost increases.

Mrs *Annette Loske* (IFIEC Europe) made a presentation on “Improving Allocation – Performance based allocation and activity rate: what is the choice?” She commented that the EU ETS in its current form has raised fundamental challenges, such as the power price effect and identified several problems with respect to relying on forecast data. According to Mrs Loske, these issues would be solved through relying on actual production data, which would eliminate the disadvantages of the present rules (uncompetitive high electricity prices, exporting and increasing emissions, hindering competitive strategies, discriminating new entrants), but would realize advantages of a

market-based instrument, i.e. providing for cost efficiency, setting the right incentives for efficiency improvements, guarantee of total cap.

**Discussions:**

The debate identified a number of requirements to be met by benchmarks: they must be simple and strictly limited in terms of numbers of benchmarks. Some Member States anticipated a risk of difficult political discussions when it comes to defining benchmarks, while NGOs underlined the need of a transparent benchmark setting process which identified the single best least CO<sub>2</sub> intensive method of production to facilitate possible linking with other international emissions trading systems. In the view of NGOs, the case for benchmarking was dependent to a large extent on their exposure to international competition and their inability to pass on costs to customers.

On request of the Chairman, representatives of industry confirmed that for the steel sector about five benchmarks one or two for the cement sector and about 20 benchmarks for the chemical sector would in their view be required.

With respect to performance-based benchmarks, representatives of NGOs and the research community took the view that they may introduce relative emissions targets instead of absolute ones and also partly eliminate or distort the carbon price signal. Without a carbon price signal, the cost-efficiency of the system would be jeopardized.

Representatives from a number of Member States, the carbon trading sector and the gas industry assigned only a supplementary role to benchmarking. For most of them, the starting point for allocation should be auctioning, as this would solve a lot of allocation problems. Generally, the burden of proof why not to auction should lie with the industry concerned. Benchmarking may only be appropriate, where it is proven that allowance costs could not be passed through and where international competition necessitates a certain level of free allocation.

The role of the carbon price signal in terms of the emissions reduction objectives to be achieved had been highlighted. A 20 – 30% emissions reduction objective for the overall economy is likely to involve a substitution effect. Auctioning could best ensure the carbon price signal required, since benchmarking and auctioning do not provide the same incentives unless, for example, a fuel switch signal were maintained in benchmarks.

Some representatives from the industry pointed out that only a decreasing share of inefficient production would bring about reductions of emissions and advocated an absolute cap for the sector and intensity targets for individual installations, which should be subject to ex-post adjustments or ex-ante benchmarks based on real production.

In the view of many stakeholders including many Member States, the carbon trading sector and NGOs, performance-based benchmarks and ex-post adjustments would run contrary to predictability and would turn out to be disastrous for the EU ETS. The same would go for other instruments such as price caps.

Representatives of the oil and gas industry took the view that internationally competing oil companies should continue to receive the bulk of their allocations free of charge until there is a worldwide carbon valuation and expressed a clear preference



for a top-down process allocating allowances for free on the basis of historic emissions. Representatives of the oil industry were opposed to auctioning, but could consider some elements of benchmarking. They also requested to take into account the so-called “Oil Refining Paradox”, which implies that efforts required by law and undertaken to produce cleaner products for customers with a view to reducing their emissions may result in greater CO<sub>2</sub> emissions inside the refineries.

In the view of industry representatives, compensation requests from the industry, as presented by Mr Steel, are justified. Some Member States did not exclude that part of the auction revenues should be recycled back to the energy intensive industry.

For some industry representatives, the proposal to give indirect allowances to power producers or direct allowances to consumers with a view to making up for increased electricity costs is an option that should be considered.

### **Conclusions**

The chairman concluded the debate by highlighting five points:

1. There is no agreement among stakeholders on the preferred allocation method. The merits and drawbacks of the various allocation methods have been presented and discussed, but the split of views remains.
2. With respect to allocation through benchmarking, it became clear that a lot of work remains to be done and that this approach is complicated and demanding. This is also clear to the industrial sectors, partly due to their work carried out in the past, partly due to anticipation of forthcoming work. The Commission does not want to discourage the industrial sectors from developing good benchmarks, but does not want to engage into another Sevilla process on BAT (best available techniques) with all its promises and limits. For this reason, the various sector associations are requested to sort out amongst themselves which benchmarks could be applicable and thus provide important input to the process conducted by the Commission.
3. With respect to benchmarking, there are serious concerns about predictability to the market, i.e. the certainty required by investors. The debate has demonstrated that the more one goes into details, the more complicated the issues become. The Commission invites all industrial sectors to look into benchmarking, but wants to make clear that ex-post benchmarks are not compatible with the way the EU ETS is set up. For the sake of a well functioning market, ex-ante benchmarks would represent a minimum requirement, while frequent and/or regular ex-post interventions are excluded.
4. There is also a matter of confidentiality, which emerges from the need to have reliable production data and other inputs when it comes to defining benchmarks. Experience showed that acquiring these data is in practice very difficult due to well-justified reasons of confidentiality and competition. The industry is requested to reflect further on these issues, since performance based benchmarks require that sort of input as a condition *sine qua non*.
5. The international dimension of emissions trading requires simplicity of allocation, in order to promote linking with other emissions trading systems. If auctioning is not the preferred approach, it would be very important to present

factual proof of how international competitiveness of the European industry is affected, in order to allow the Commission to take the matter of international competitiveness into account when it comes to proposing allocation methods. The issue of recycling of revenues from auctioning would also be an important aspect to consider.

**Agenda item 4: Carbon price signals, allocation methodologies and international aspects including electricity prices**

**Presentations**

On behalf of WWF, Mr **Stefan Singer** presented “The economic and ecological impact of different allocation methodologies – grandfathering, benchmarking, auctioning”. Mr Singer identified a need for a single EU-wide cap that is aligned to 30% + greenhouse gas reduction limits by 2020. He advocated a cap level for 2020 with a percentage of periodic 5 years decrease to be set in the directive as well as starting the debate on 2030, 2040, 2050 EU ETS cap level.

WWF recommends that all permits should be auctioned as there is no other equally transparent, equitable and non-distorting method of allocation. With respect to auction revenues WWF recommends that the distribution of all money generated is transparent and publicly accountable and used for climate protection. A substantive part of money should be invested in developing nations to facilitate technology transfer, European export industries and lead to an increased uptake of clean carbon solutions.

Mr **Jos Sijm** (ECN) made a presentation on “The impact of the EU ETS on electricity prices: experiences from the past and expectations for the future”. According to his findings, the main price drivers on 2005 forward markets, in the case of gas fired power generation were fuel and carbon costs, while for coal-fired plants only carbon costs were identified. In Mr Sijm’s view, carbon pass through is not a problem, but an intended effect. On the other hand, he noted that although overstated generally by energy-intensive industries, it is an issue for some sectors. Carbon pass through and windfall profits would continue in the future, although the impact in the long run will be mitigated by induced additional investments in generation capacity. In this respect, he stressed that however, free allocations undermine the incentive structure towards carbon reducing investments. A shift of free allocation to auctioning will have a beneficial impact on carbon reducing investments, reduce (windfall) profits of fossil generators, but most likely not have a (significant) impact on cost pass-through or windfall profits of non-fossil generators.

Mr **Simon Baker** (Eurometaux) made a presentation on “The impact of the EU ETS on electricity prices – perspective from non-ferrous metal producers operating in Europe”. As for the observed CO<sub>2</sub> pass-through into power prices, Mr Baker explained that including the opportunity cost of CO<sub>2</sub> in pricing decisions is fully consistent with economic theory. Non-ferrous metal producers need long-term predictable cost-based power supply arrangements. Uncertainty on the future tightness of the carbon constraint, allowance allocations and methodologies makes pricing long-term power supply agreements very difficult. Consequently power generators are either unwilling to enter into long-term sales arrangements or will look to push the CO<sub>2</sub> price risk to the consumer. Non-ferrous metals are globally traded commodities;

producers cannot pass-through local cost increases such as the incorporation of the CO2 cost into power prices in Europe.

As a consequence, shielding measures from the pass-through effect of CO2 into power prices would be required, otherwise trade-exposed energy intensive industries in Europe such as primary aluminium production will close and be replaced elsewhere with no overall environmental benefit.

Mr Baker proposed that long-term power sales to trade exposed energy intensive industries should be entitled to an equivalent free allocation of allowances. In Mr Baker's view, such an approach does not affect fundamentals of the scheme nor monitoring and reporting and would remove CO2 indirect effects in power prices.

In his presentation on "Impacts on electricity prices of emissions trading", Mr **Bill Kyte** (Eurelectric) stated that changes in electricity prices would not be a consequence of emissions trading, but of implementation of the Kyoto Protocol. As the trading scheme is the cheapest way to implement Kyoto, it means that any price changes will be the lowest necessary. He pointed to electricity price increases starting already in 2002, while the EU ETS came into effect in 2005. Real prices, however, were, according to Mr Kyte, still lower in 2006 than they were in 1990, while a threefold increase in taxes from 4.2% in 1995 to 13.2% in 2006 contributed considerably to the power price rise.

He also argued that electricity prices in the US even rose more than in Europe (before taxes) compared to 1995. Also fossil fuel prices went up more sharply than power prices with oil price increases amounting to 186% (1995 – 2006), gas prices to 133% and coal to 34%. The same would go for the metals and chemicals sectors with aluminium up 60% compared to 1997, steel a little bit less than 60% and copper around 20% (yearly average, based on \$-prices), while in the chemical sector ethylene, ammonia and methanol show price increases between 40 and 140%.

As regards the impact of non-EU competition on the ETS sectors, he referred to a Climate Strategies study conducted on behalf of DEFRA, which for most ETS sectors did not reveal any significant value at stake, even in the scenario where no allowances were allocated for free.

In his conclusions, Mr Kyte underlined that the objective of the EU ETS is to deliver carbon reductions at the least cost and the impact of the EU ETS on competitiveness has been over-hyped. Key principles for allocation could be equity between installations, predictability and harmonization.

Mrs Sophie **Dupressoir** (ETUC) presented the viewpoint of European Trade Unions on "Allocation of carbon permits, competitiveness and employment". She outlined that for energy intensive industries (EII), there is a threat of relocation and there might be the risk to head towards a 'lose-lose' situation made up of the loss of European industrial basis and the loss of potential of emissions reduction. The industries concerned would not account for more than about 1 percent of EU employment. A study conducted on behalf of ETUC showed that, in most cases, the sectors are not putting enough effort into R&D.

The level of auctioning should depend on the level of exposure to international competition, while the risk of relocation could be minimised by a border adjustment mechanism. She concluded that there should be as much as possible harmonisation in the EU ETS. It should also be backed up by stronger and public R&D funds to bring

the necessary technology breakthrough. The transparency of the allocation process is considered crucial, even if auctioning and benchmarking are applied.

Mr **Christoph Grobbel** (McKinsey & Company) made a presentation on competitive effects. Power plants are generally profiting from EU ETS, but to a different extent: while nuclear power does not face any cost but revenue increases, revenue increases of lignite, hard coal and old gas fired power plants would mainly depend on free allowances, as not all cost increases could be passed through (merit order).

While revenue increases in the refining sector under free allocation clearly outweigh cost increases, cost and revenue increases in the steel and cement sector would just level out each other. All of these sectors, with the exception of EAF steel, however would depend on free allowances. The aluminium sector faces pressure also with free allowances, since there are no revenue increases but only increasing costs.

In summarising the lessons learnt, he concluded that competitiveness issues should be addressed. This could either be done through a cross border taxation scheme or production based allocation with benchmarking or auctioning with redistribution of the proceedings. In the event of a global sector agreement, the issue would be resolved, too. The allocation mechanism would determine the “pricing-in” of CO<sub>2</sub> allowance value.

For the steel industry, Mr **Paul Brooks** (Eurofer) presented “A Proposal for A Sector Approach”. Taking the view that the current EU ETS does not deliver a global reduction in CO<sub>2</sub> emissions and will not help achieving a reduction of CO<sub>2</sub> emissions by 30% by 2020, he proposed an alternative ETS based on a baseline and credit system. He described its main characteristics – a mandatory scheme for the steel sector, including direct and indirect emissions on the basis of a baseline. The system would offer a clear incentive to invest in improvements and provides major advantages, such as quantified emission reduction performance, real reward for innovation, avoiding delocalisation of emissions, no barrier to growth, and it has a real potential to become global.

Mr **Richard Baron** (IEA) made a presentation on the economic role of carbon price signals emerging from the EU ETS. It is to internalise the social cost of CO<sub>2</sub> and to optimise choices on that basis. In electricity, the carbon price signal is working. Emissions trading is a cost-minimising policy instrument and would determine the appropriate carbon price. Asking whether the same environmental outcome could be delivered at lower cost, he confirmed that this would be possible on condition that incentives to lower emissions are unequivocal, and uncertainty can be lowered through commitment periods and increased visibility to investors.

With respect to CO<sub>2</sub> and competitiveness with outside the EU, the priority should be to seek least-cost reductions through emissions trading. In order to improve the ability of the scheme to deliver a CO<sub>2</sub> price as low as it could be, the review should bring about new rules to lower uncertainty.

According to Mr Baron, the market base of our economies makes CO<sub>2</sub> pricing a central coordination tool, yet other policy instruments are needed to overcome market barriers and distribution issues must be addressed.

### **Discussions:**

In the debate, NGOs highlighted that with respect to international competitiveness, some presentations have shown that cost issues are not as serious as claimed and requested data on industry's exposure to international competition. While some Member States took the view that, where justified, concerns about competitiveness must be addressed by means of a compensation mechanism including reinforced work on border tax adjustments, reference was also made to studies showing that a high level of auctioning would be possible for energy intensive industries without impacting on leakage.

Representatives of the carbon trading sector took the view that leakage is often confused with the impact of globalisation. With respect to a proposal presented, they stressed that Europe would give the wrong signals if it were to have industrial sectors leave the EU ETS.

Auction revenues should be used to help other countries invest in clean technologies or export credits. NGOs suggested that auctioning could reduce the costs for the society in comparison to taxes.

Some industry representatives questioned some of the figures shown in some presentations and pointed out they would not apply to energy intensive industries. They also had doubts whether the results of a recent study published by DG Competition have been taken into account with respect to market distortions.

### **Conclusions**

In summing up the debate, the Chairman identified three points:

1. The economic impact of the EU ETS is there and has created price effects throughout the economy.
2. As regards international competitiveness, there are direct and indirect impacts. Factual evidence on these impacts will be needed and it is important that this evidence is made clear. The EU ETS will be reviewed, however, without compromising its environmental strength and integrity. It is also a matter of fact that globalisation is ongoing.
3. In the event that negative impacts from international competition can be established, there may be different ways to deal with them:
  - differentiated allocation of allowances
  - different allocation method, e.g. between the power and the industrial sectors
  - The baseline and credit system, presented by Eurofer, however, would not be compatible with the EU ETS.
  - Border tax adjustments or similar compensation mechanisms might be considered, when it comes to compensation.

### **Agenda item 5: Options for benchmarking**

#### **Presentations**

Mr Mariano Morazzo and Mr Fabio Romani (Italy) presented “Benchmarking – methodology for allocation”. They presented a general definition of benchmarking, as

well as the use of benchmarks (BMs) for allocation, where they could be used for both cap setting and distribution. Benchmarking entails a number of advantages, such as transparency, an incentive in favor of low carbon products and technologies and it can account for growth and market share of the installation concerned. As a drawback, the need for quality data on processes and products was mentioned.

The definition of products to be taken into account may be a trade-off between simplicity and equal treatment. Too many BMs reflecting different technologies or products would only deliver small advantages compared to grandfathering.

Mr Morazzo concluded that there are issues to be overcome and technical options to be assessed, such as outsourcing, data consistency and confidentiality, installation and process boundaries, products and technologies, fuel (in)dependent BMs etc. On the other hand, benchmarks represent a flexible policy tool that could bring environmental and economic benefits.

Mr ***Tomas Velghe*** (Belgium) presented the role of benchmarking in the EU ETS. His presentation primarily focused the distribution of EU ETS emissions among Annex I-activities, the role of benchmarking in determining sectoral caps and the role of benchmarking in individual allocation methodologies.

When it comes to the role of benchmarking in determining sector caps, the EU commitment to at least a 20% reduction has to be translated in an EU ETS and non-EU ETS cap. This should happen following combination of a “grandfathering” and “equity based” approach made at EU-level.

As regards the role of benchmarking in individual allocation methodologies, a strong (non-fuel specific) benchmark should be used for all fossil-fuel fired power plants in the electricity sector. The rest of the allowances within this sectoral cap could be auctioned or set up as EU-wide reserve.

In some specific industrial sectors, existing benchmarks are being developed. Mr Velghe advocated applying EU-wide benchmarks in these sectors for the sake of a level playing field. As for smaller sectors, Mr Velghe did not exclude BMs, but considered them to be too diverse.

Mr ***Paul van Slobbe*** (Netherlands) made a presentation on “Benchmarking and NAP-III”. Since allocation should be fair, Mr van Slobbe excluded grandfathering and advocated auctioning as the best method with benchmarks as a supplement if politically required. Simplicity and predictability should be key starting points as criteria for benchmarks. EU allocation norms should be set for existing plants and for new entrants, but only major products/processes covering approximately 80% of emissions with the balance leaving to Member States or excluding them from the scheme (Pareto concept).

He proposed to launch a pilot project with clearly defined objectives and features, which should be finished in October 2007 and should provide input to the review of the EU ETS. Summarizing his presentation, Mr van Slobbe highlighted that setting the total ETS cap is an autonomous process; allocation should be done by auctioning and, where necessary benchmarks; the real small emitters should be excluded; EU benchmarks for the major few should be developed and kept simple; smaller emitters should be left to discretion of MS; a pilot project should be started with MS taking the initiative.

### **Discussions:**

The debate revealed a considerable number of arguments for and against using benchmarks for allocation.

Several Member States were open to support benchmarks, but acknowledged their complexity, also involving the risk of over-allocation to efficient installations. Others highlighted that local circumstances should be taken into account as well as the structure of the power sector and political considerations. Representatives of energy intensive industry advocated considering benchmarks, as the impact of auctioning on customers of the power generation sector has to be taken into account. On the other hand, NGOs highlighted the risk of distortions arising from the implementation of benchmarks, which may result in 27 rather than one benchmark in one sector. This could not only have protectionist effects, but would also send the wrong signals. Contrary to benchmarking, auctioning would sort out a number of problems (see below) without creating additional costs compared to the current pass-through situation. Representatives from the academic research community proposed that revenues from auctioning be used to support innovation in sectors exposed to international competition.

Some Member States showed some sympathy for the Dutch proposal to have EU-wide benchmarks only for the key sectors and considered it a matter of the industry concerned to come forward with appropriate benchmarks. While other Member States identified EU cap setting as a prerequisite for EU-wide benchmarks, which might be based on historic rather than projected data, experience of some Member States advised to refrain fully from production figures, as it failed to work. Some industry representatives said that fuel switching, e.g. from coal to gas, as a means to reduce emissions might not always be possible and, since the process side would not allow any reduction at all, emissions reductions might not be possible. One Member State asked for considering whether a benchmark with a correction factor for grandfathering allocation could be explored. A representative of the energy intensive industry announced that the European lime industry is investigating to go for an EU-wide benchmark taking into account the technical potential of reducing emissions.

From the point of view of representatives from the academic research community, benchmarks could only be the 2<sup>nd</sup> or 3<sup>rd</sup> best solution, since any updating component of benchmarks would create a major distortion of the price signal to the market, while the yardstick should be a non-distorted price signal. Such distortions could also be expected, if a fuel-specific benchmark was to be applied. Output based benchmarks in the 3<sup>rd</sup> trading period would increase inefficient production in the 2<sup>nd</sup> trading period.

According to the Commission, state aid issues may be raised, if rewarding best performers would mean to allocate more allowances than they need. While some Member States argued that this could only be avoided by using benchmarks based on BAT (best available technology), other Member States took the view that granting more allowances to more efficient performers should not be seen as constituting state aid. In their view, this should be clarified in the Directive. In the view of industry representatives, there should not be any prohibited state aid involved as long as there is an environmental counterpart. The system should not only stimulate BAT, but improving BAT. For this reason, it would be counterproductive, if best performers receive fewer allowances. The yardstick for allocation should be the incentive to invest. Industry representatives also pointed out that amortized assets are usually the

cash cow of the industry, since they incur only variable costs, but they are very often very old and thus inefficient compared to new installations. In the case of non-amortized installations, too few allowances would turn them into stranded assets. This could only be avoided by setting very long-term, i.e. 25-30 years, benchmarks.

The Commission noted that performance-based standards require a solution of the confidentiality problem, which would arise when setting the benchmark. The problem would not only occur vis-à-vis the authorities, but even more among the companies of one specific sector. Representatives from the industry suggested that this problem could be solved through outsourcing, if the rules were clearly laid down and if the “how” was solved. According to the experience of some Member States actually applying benchmarks, the confidentiality problem is still pending. It has also been highlighted that disclosure of allocation data would inevitably reveal production data, and thus underline the confidentiality problem. Representatives from the energy intensive industry set out that much information would already be available from publications in the framework of EMAS and others. In the case of ex-ante benchmarks, the matter of confidentiality would not create any problem, as it would only matter for the shareholder market. According to one Member State, 80% of production figures are already available, while the Commission underlined that data gathering would create a lot of work for Member States. Representatives of the energy intensive industry drew attention to the fact that for example data published by the IEA do not necessarily match between countries and categories or sectors, as used by the CITL. It would be important to ensure that IEA and CITL data were in line.

Some Member States and a Commission representative considered simplicity and transparency of benchmarks to be key to convince other countries, such as the G8 plus five to link up with the EU ETS, while a energy intensive industry representative took the view that simplicity is not always easy to achieve and might not always be appropriate for a benchmark. Other industry representatives stressed that EU benchmarks must be kept simple, not least for linking purposes. In addition, they suggested that, for the sake of a global carbon market, global benchmarks should be developed, since the US and Australia would develop an ETS based on performance standards. Against this background and referring to current developments in the US, NGOs strongly advocated auctioning as the only credible allocation methodology.

Doubts were raised concerning the feasibility of benchmarks when it comes to linking the EU ETS with China, on the basis that neither side could be expected to accept a more ambitious or stringent benchmark than their own. Representatives from the industry took the view that this consideration should not be a matter of concern now, because such a system would still be 10 to 15 years away and that China is always using brand-new technology anyway.

The Commission raised the issue whether performance based benchmarks, which are to provide more flexibility would still require a reserve. Some industry representatives took the view that a reserve for growth would always be needed, in order to take into account the growth of the whole economy.

Several Member States supported the idea of a pilot as proposed by the Netherlands. One Member State raised doubts whether refineries would be the most promising sector for the pilot and suggested that aluminium and steel would represent good starting points. A representative of the energy intensive industry announced that the



lime industry would volunteer for the pilot subject to decision of the relevant industry board.

### **Conclusions**

The chairman summarised the debate by highlighting five points:

1. The presentations have shown that there could be a role for BMs in overall cap setting and allocation. In determining an EU-wide cap, this could take into account EU sector caps, for which BMs could be extremely useful, in order to minimise potential competitive distortions.
2. Full auctioning would mean that there is no need for BM and vice versa. 100% auctioning would also mean that there are no state aid concerns. A strong conclusion is emerging from the debate: both auctioning and BM need a clear long-term perspective, in order to be efficient from an environmental point of view.
3. There are a number of different definitions for BMs, such as technical standards, norms, BAT or correction factor of grandfathering. It is useful to have many different definitions, as it might be difficult to have a one-size-fits-all approach employed. There seems to be agreement that a BM should be EU-wide, and if possible, should have a global dimension. There must also be only a limited number of benchmarks with a limited number of installations. While simplicity would be very important, there is caveat meaning that this principle comes under pressure, if one goes into the details.
4. Problems to overcome with respect to BMs are
  - the data requirements, which may be extensive and challenging, but not impossible to overcome, although the debate highlighted a new problem accruing from the incompatibility of international data basis, which would bring about an additional layer of complexity.
  - the confidentiality issue, where some stakeholders take the view that one could be transparent on matters, but does not necessarily have to be on data, while other think one cannot hide them as the credibility of the BM would be at stake. While there may be ways to overcome the problem by involving a third party, the issue remains a delicate one requiring a balance to be made.
  - punishing those lagging behind is right, but might be politically difficult to achieve.

There is also a need to minimise interference of the public sector by, e.g., ex-post adjustment, which would de-stabilise the market and runs counter the set-up of the EU ETS. All in all, BMs entail considerable problems, which however are not impossible to overcome.

5. A pilot exercise would be welcomed by the Commission, since it would allow taking stock of the experience of Member States, but it should be done with an EU-wide, if possible global dimension in mind. It could be done by a small group of experts in the framework of the Climate Change Committee, where a

case could be selected to provide insights for the Commission when elaborating its legislative proposal. Input of the industrial sector would be welcome.

## **Agenda item 6: Options for Auctioning**

### **Presentations**

Mr **Kjell Olav Kristiansen** (PointCarbon) made a presentation on „Auctions – new market dynamics“. He concluded that

- There must be clear objectives behind EU/MS auction strategy addressing the issues of market power, price regulation etc;
- It is important to understand market behaviour and timing considerations
- Carbon exchanges/energy trading platforms should be used for auctioning (routines, software, clearing routines etc at hand)
- The number of ”auction houses” and frequency of auctions should be limited
- A uniform price auction appears to be a simple and most common approach
- There should be low barriers to participation, in order to keep transaction costs as low as possible.

Mr **Karsten Neuhoff** (University of Cambridge) presented design options for auctioning under a single EU-wide cap or national caps. He concluded that

- A simple auction design would win participants and for this reason, a sealed bid, uniform, frequent auction design, commissioned to institution with existing operations is likely to be best. Open issues in this respect would be whether the distribution across auctions would be uniform.
- Harmonisation of auctions would be simple but effective. They could be simplicity and thus facilitates participation and avoid lock in. The possibility to commissioning auctions to one institution should be jointly considered.

Mr **Andrei Marcu** (IETA) presented IETA’s views on auctioning. He presented arguments in favour and against auctions and identified a number of requirements of auctions such as transparency and simplicity of auctions, recycling the bulk of proceeds, a long-term regulatory predictability, periodic and coordinated auctions without causing large distributive effects, harmonised design and gradual implementation of auctions and the need for new investment.

He concluded that recycling of revenues should not be used to introduce new market distortions, but should be used to remove existing ones. If auctions are introduced, it must be introduced gradually, taking into account the level of development, especially scope, of the global GHG markets and concerns over competition.

Mrs **Gyorgyi Gurban** (Hungary) presented the Hungarian experience with auctioning in the 1<sup>st</sup> period. In Hungary, allowances are considered an asset of the Hungarian national treasury, which is very different in other Member States. For this reason, harmonising the legal nature of allowances across the EU has been recommended. The Ministry of Finance has been nominated to be in overall charge and contracted a company, in order to implement an electronic auction. The whole process turned out to be very long, but the system worked well in overall terms. It was decided to use the

revenues up to a certain level for climate adaptation and mitigation measures. Mrs Gurban recommended to set up rules at EU level on how the revenues should be used, at least in order to make sure that they do not run counter the whole system.

Mr **Ken Macken** (Environmental Protection Agency, Ireland) presented the experience on “Auctioning Greenhouse Gas Allowances” in Ireland. For NAP1 the Irish Government had directed EPA to auction up to 1% of allowances to defray the costs of administering the emissions trading scheme. Two auctions took place, the first in January/February, the second in December 2006. Mr Macken identified a number of lessons learned from auction 1, from which auction 2 in December benefited:

- Electronic transfer of deposits and matching to account holders was not as straightforward as Irish authorities had been led to believe – the full data string did not appear on their on-screen bank account.
- Time-lines for electronic funds transfer were generally very fast – two days would appear to be sufficient. Hence settlement time-lines could have been shorter than the five days in the 1<sup>st</sup> auction.
- Refunds to unsuccessful bidders was straightforward for those in the eurozone, but slower for those outside the eurozone as authorities needed to ascertain if the return account was a euro account or a national currency account.
- Vulnerability of auction if market dipped during settlement period. The deposit of €3,000 was insufficient to ensure payment of accounts and was increased to €15,000 in the 2<sup>nd</sup> auction

Mr **Tomas Wyns** (CAN-e) made a presentation on allocation methods post 2012, which in his view have to be auctioning and an EU-wide cap. He strongly advocated full auctioning as single allocation method post 2012 on the following grounds:

- Transparency: auctioning would not need any complicated formulas, historical data, benchmarks etc;
- Auctioning would convey a clear CO2 price signal;
- Auctioning would provide a better incentive for price internalisation and hence promote investment in energy efficient, renewable technologies, which, according to Mr Wyns, will be needed anyway, bearing in mind reductions needs by 2050 in the order of up to 80%.
- Auctioning would eliminate windfall profits and intra EU distortion of competition and would provide a solution for new entrant and closure issues.

His final conclusion was that auctioning is, in principle, the best method to allocate allowances.

### **Discussions:**

In the debate, a number of Member States clearly spoke out in favor of auctioning, some of them advocating full auctioning from 2013 onwards. Representatives of the industry were opposed to auctioning before a global agreement was reached, as the effect of auctions would in their view represent a variable and unpredictable tax on business, would accelerate further slipping behind in terms of EU R&D expenditure

compared to the US and Japan and would affect investment decisions and the ability to invest by reducing the profitability of investments within the EU energy intensive industry relative to investments outside the EU. Renewable energy generators argued that auctioning would remove investments from dirty industry and shift them to clean industry, thus providing the right investment signal. They also stressed that auctioning would remove market distortions and align with the “polluter-pays-principle”.

Stakeholders had differing views on the extent to which harmonisation of auctions should be pursued or would be necessary. According to representatives from the academic research community, empirical evidence does not prove large differences of auctions in terms of results/outcomes. While industry representatives underlined the importance of harmonising auctioning across the EU, some Member State representatives spoke out against harmonisation of auctioning rules in favour of minimum standards in the form of Commission guidance. Representatives of the carbon trading sector took the view that much experience is already available from auctions in other sectors, but considered it necessary to discuss the right way how auctions would be phased in. It has also been highlighted that, in terms of coordination and timing, early announcements would be needed. The 2<sup>nd</sup> trading period would also allow time to coordinate and identify appropriate solutions including identification of a third body to implement the auctions on behalf of Member States. Some representatives of the industry shared this view. Representatives of the energy intensive industry pointed to the Irish example using small auctioning slots, which could work, but had doubts, whether such an approach would be feasible at EU level.

They also raised doubts whether free access to auctions can be guaranteed to all including small emitters. According to some Member States, this should not be a big issue, since secondary markets would be open to all and the market would offer relevant services. Representatives of NGOs also took the view that small companies would have plenty of opportunities to buy allowances, while representatives from the academic research community pointed out that a uniform price approach implied all are paying the same amount and would therefore be rather simple also for small parties. In addition, frequent auctions would make it difficult to exercise market power and would render the market less vulnerable to price shocks. Representatives of the gas industry underlined that the auction design, such as the frequency of auctions must be well known at the beginning of the period, as auctions have to be designed to supplement secondary markets, in order to enable them to underwrite investment decisions.

While representative of the energy intensive industry took the view that auctions would result in higher electricity prices, representatives of the carbon trading sector were convinced that auctioning would not lead to rising allowance prices, since the costs of allowances are already passed through. In this respect, representatives from the academic research community underlined that free allocation would inevitably lead to a distortion of the price signal and in the longer term to higher CO<sub>2</sub> prices and thus higher electricity prices.

With respect to the use of auction revenues, several Member States representatives were of the view that the decision on their use should taken by Finance Ministers, most of them however did not exclude that at least a part of these proceedings should be spent for environmental purposes, for example through creation of a climate fund,

if there were justified needs. One Member State asked for a study of the Commission whether recycling of revenues to the energy intensive industry would constitute state aid, while industry representatives argued that the use of auction revenues must not be left to the discretionary actions of Member States, but should be used for R&D measures with a view to helping the industry affected by international competition or for promoting technology transfer to developing countries. The argument that revenues must not disappear without any benefit for the environment was also strongly supported by representatives from the carbon trading sector, who pointed out that the ETS has been set up in order to address environmental concerns, but not to raise revenue. In their view, the EU ETS would be undermined, if revenues were not used for environmental purposes.

### **Conclusions**

In his conclusions, the Chairman raised three points:

1. There is a lot of support for auctioning because of its merits in terms of transparency, delivering a clear price signal, avoiding windfall profits and others. The merits have to be balanced against the concerns relating to international competitiveness, however, this would not apply to all sectors, but only those which can adequately demonstrate that they are exposed to international competition or which cannot pass through their costs. The bottom line with respect to both benchmarking and auctioning, however, is that there should not be any new distortions or that the risk of new distortions should be minimised.
2. Problems raised in the debate from a policy perspective concern the potential creation of market power and the requirement not to bring about any instability, which would both speak out in favour of frequent auctions. The timing of auctions is important, as is the gradual nature of their introduction. Predictability also plays an essential role with a view to avoiding upsetting the secondary market. Another crucial issue is how to guarantee access to all market participants including the small ones. Auctioning would also bring about a new EU dimension, i.e. the matter of using revenues, which could be implemented nationally. There is scepticism about decentralised handling of auctions, as this may lead to new distortions. Unproductive conditions arising from 27 different auctioning systems have to be avoided.
3. A solution on how to use revenues is technically possible, but is politically less straightforward. While some maintain that the use of revenues should be fully open for national treasuries to decide, others stressed that new distortions must be avoided. Thus, it represents a new issue to look at. There have been many suggestions how to use auctioning revenues including measures to reduce greenhouse gas emissions, to promote new technologies and R&D, to reduce corporate taxes or to introduce them to the EU budget, from where it would be recycled to Member States. There is also a strong EU dimension with respect to state aid.

**Agenda item 7: Possible options for allocation under the EU ETS post 2012**

**Agenda item 8: New entrants**

**Agenda item 9: Closure of installations**

**Agenda item 10: Monitoring and reporting**

**Presentations**

Mr **Daniel Radov** (NERA) presented options for allocation under the EU ETS post 2012. He then presented options to harmonise allocation matters taking as a starting point the currently existing situation. The options identified included maximum, moderate and low harmonization. In a preliminary evaluation of these allocation options, Mr Radov arrived at the following conclusions:

- Environmental integrity refers to certainty of a EU-wide cap and the risk of leakage. The proposed options improve on status quo in terms of cap, some are more designed to prevent leakage than others.
- Efficiency of trading scheme refers to the ability to achieve emissions reductions at least cost. Key negative factors are allocation to new entrants, differentiation of new entrant benchmarks, and updating—but keeping in mind real-world complications would be important.
- Administrative costs and feasibility depend primarily on data requirements, sensitivity of data, and number of independent Member State allocation approaches. Recent production data may be sensitive.
- Fairness is difficult to quantify or judge objectively. Is it “more fair” to allocate the same to all, or more to those facing competition, or to those producing more, or to those innovating the most, etc. ?

As for the matter of new entrants, Mr **Hans Henrik Lindboe** (Denmark) presented preliminary results of a study on “Impact of suboptimal design features in the EU ETS – Allocation in the electricity market”. He outlined the impact on the electricity spot market dispatch demonstrating that the merit order of electricity supply is affected by CO<sub>2</sub> costs rendering gas more competitive than coal. A similar effect could be observed with respect to the long-run marginal costs of electricity generation, which are decisive for investment decisions. As a consequence, wind power would be as competitive as gas, but more competitive than coal. In an optimal design, the impact of emissions trading on the electricity spot market would ensure efficient CO<sub>2</sub> reduction and provide incentives to invest in low carbon technologies.

He then outlined the project, the goal of which was to assess the impact of free allocation to new entrants in the EU ETS. The overall outcome of the two scenarios examined under the study showed that free allocations to new entrants would distort the market. Overall economic welfare losses in the area researched would amount to more than € 15bn at a price of €30/tCO<sub>2</sub> amounting to 25% of investment.

Mrs **Ann Gardiner** (Ecofys) presented a “Definition of new entrant” and identified four harmonization options. She concluded that there are strong arguments in favor of harmonizing new entrant rules, which should be linked to overall decisions on harmonization of future phases of ETS. An EU rule book could begin harmonization and could set out the long term approach. In the long term, a total remove of NER and closure rules could be considered.

Subsequently, Mrs *Ann Gardiner* (Ecofys) presented options for harmonisation of closure rules. She identified the same options as for new entrants, which have to be informed by worked examples of real closure and transfer, a route map for long-term future and an approach to international competition.

### **Discussions:**

With respect to the presentation on harmonisation of allocation, some Member States suggested that the study should also include practical examples how various harmonization options would work out for Member States. Other Member States may prefer a mixture of the three options presented.

Representatives of several Member States, the carbon trading sector, NGOs, industry representatives and the research community taking the floor agreed on the need for more harmonised new entrants reserve (NER) most likely at EU level. In the view of most of them, there would not be a need for a NER for the power sector, which should be allocated through auctioning. However, in the event that there is no full auctioning, almost all stakeholders advocated applying the same approach to incumbents and new entrants, for example, based on high performing benchmarks.

According to representatives from the academic research community, the need for consistency between allocation, the NER and closure rules has to be respected. Free allocation to new entrants could have the potential to distort between different fuels and undermine the incentive to move to low carbon production. This observation was also confirmed by the study presented by Denmark, as pointed out by one Member State.

The short debate on closure also highlighted the need for harmonisation in line with the approach taken on the NER. However, while some stakeholders, such as NGOs, advocated canceling allowances after closure, in order to promote an increasing stock turnover, others, such as representatives from the energy intensive industry argued that if allocations from installations closing down are taken away, inefficient plants would run longer.

Representatives of the energy intensive industry suggested that the impact assessment of the Commission should show the impact of the different options on Member States and sectors. The Chairman reassured participants of the meeting that the Commission would do as much as possible, but would not promise perfectionism, as there are too many design elements.

### **Conclusions**

The chairman drew the following conclusions from the debate:

1. There is strong evidence that considerable welfare losses would emerge from non-optimal design options, as has also been demonstrated by the Danish study on new entrants. The matter is not the degree of harmonisation, but how the best results can be achieved in terms of environmental, economic and administrative efficiency.
2. The nature of a NER will need to follow the overall allocation methodology: if full auctioning is pursued, there will not be a NER. In the case of BMs, the

same rules should apply to new entrants and in the case of an EU-wide cap, there must be a EU-wide NER.

3. There is a strong appeal that NER and closure would be the same issue, as they go hand in hand. The timing issue would be very important in this respect. The discussion has demonstrated that the better the allocation methodology, the less worries would occur on closure rules, as they are perceived as a failure of allocation methods.

**Agenda item 11: Concluding Remarks by the Chair**

The Chair thanked all participants for their contributions to a very helpful and thorough outcome of the meeting and drew their attention to the final ECCP review meeting scheduled for 14 and 15 June.