The Centre for European Policy Studies
Thinking Ahead for Europe

3rd meeting of the
ECCP working group on emissions trading: Further harmonisation and increased predictability

Pros and cons of national caps and the impact on the internal market

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Allocation

creation - distribution – use of emissions rights

Cap setting – macro
(creation of emissions rights)

Highly decentralised

→ reflecting EU structure

Industry-MS negotiation

Allocation (-methodology) - micro
(distribution/use of emissions rights)

Highly decentralised

→ reflecting EU structure

Each MS develops own rules

Looking back

2000 Green Paper identified internal market aspect

- "avoid .. distortions to competition"
- "Industry needs to be sure of receiving fair treatment in every Member State and between comparable companies in different Member States"
- " … trade-off between providing greater equality of treatment and more simplicity on the one hand, and Member States maintaining greater autonomy on the other".

Source: 2000 Green Paper, p. 12

Green Paper, p. 12/13

- "How to ensure … equivalent effort" (= cap-setting)
- "How to distribute … allowances … to prevent indirect discrimination and minimise distortions" (= allocation)

Positions to Green Paper

- A, B, DK, S in favour of harmonisation, especially EU cap setting (and sometimes) EU allocation.
- NL, I, Ire, UK in favour of member state autonomy (UK: “rules … not to be too prescriptive” (Scottish Environment Agency for “common allocation”).
- Finland no position; France for harmonisation for energy-intensive industries and opt-out at same time.
- EP for member state allocation

How the EU ETS was adopted

- Result of consultation with stakeholders – ECCP and beyond
- Unanimous agreement in Council, Big majority in EP; high stakeholder support

→ **Political consensus included two key features to ensure adoption:**

- **Free allocation** – to "buy industry"
- **Allocation remains in the hands of Member States (MS)**
  - price to pay for Commission
  - Industry feels more comfortable with MS allocation (e.g. PriceWaterhouse Coopers 2005)

→ Attempts by the EP to reduce MS discretion failed

→ EU could not even agree on a common methodology to allocate (other than "free allocation), lack of installation definition, lack of EU-wide MRV

Cap-setting and allocation are highly decentralised negotiation processes

- EU competencies (subsidiarity)
- Member states to avoid “too much” Commission power
- Industry preference
- Reflects material differences of member states

Costs of decentralisation

1. **Distortions in internal market (allocation can involve high values)**

Allocation (NAP 1)

CHP plant

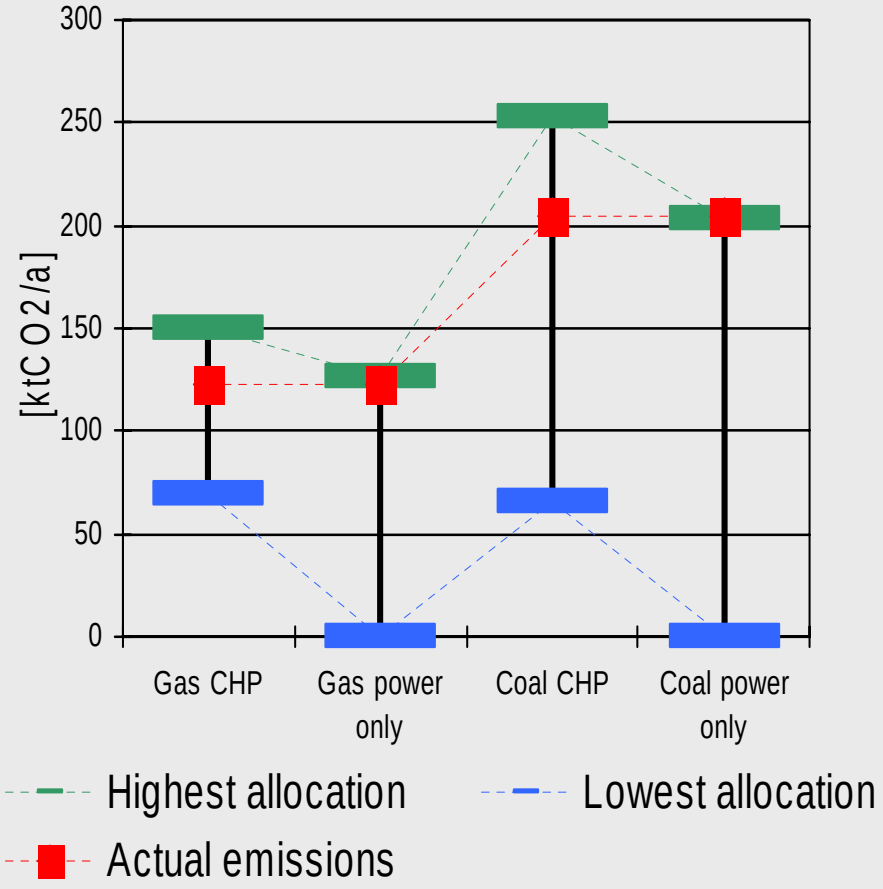
- Germany: 130% expected emissions
- Finland: 120%
- Denmark: 90%
- Sweden: 60%

Gas combined cycle:

- Germany: 105%
- Finland: 100%
- Denmark: 82%
- Sweden: 0% (non-CHP does not receive allowances)

Source: Åhman and Holmgren, 2006

Distorting competition: Allocation to new entrants in eight Baltic Sea Countries



- **Model plant: A new installation of 100 MW fuel input (gas-CHP, Gas-CCGT, coal-CHP, coal condensing)**
- **The graph shows the actual emissions of the plant and the variation (hi-lo) of allocation in different countries: a certain country may allocate more than the actual emissions, the other one nothing**
- **The maximum differences in monetary terms:**
  - at 5 €/tCO2: 1 M€/a
  - at 20 €/tCO2: 4 M€/a
  - At 30€/tCO2: 6 M€/a

Source: Niininen, Fortum

Costs of decentralisation

2. In many cases, lack of incentives in low-carbon technologies (perverse effects) as result to accommodate incumbents
3. Complexity, administrative burdens, transaction costs
4. Novel feature of new entrants/closure/transfer rules → have not been known before

   a) distinction expansion/new investment difficult

   b) closure rules create perverse effects

   c) Creation and management of NER is difficult

5. **“Expected” shortage in power sector in most but not all countries < depending on industry pressure (Allocation a means to compensate industrial sector)**
6. **Development of national benchmarks (emissions factor and activity rate)**
7. **Major distorting factor is 1998 EU-15 Burden-sharing agreement**

NAP 1 Experiences/ NAP 2 Improvements

Cap-setting: experiences phase 1

- **MS used differentiated criteria somewhere between "less than BAU" and "moving towards Kyoto path"**
- **Projections were inflated (LETS Update, 2006): combination of modest reductions and inflated projections are disastrous**
- **Inefficient pie split: ETS cap has been too high**
- **Ample examples for distortions**

Phase 2 improvements

Cap-setting (macro)

1. **Member states have less leeway for Kyoto consistency**
2. **Commission could correct MS projections – PRIMES model**

Allocation and allocation methodologies (micro)

3. **Real shortages after NAPs (-15% but equals max. CDM/JI intake)**
4. **Better pie split between ETS and non-ETS sector (overall strategy)**
5. **Some increase in benchmarks**
6. **Auctioning increased but still small (0.13% to 1.2%-1.8%) ; UK 7% auctioning is highest observed in any existing scheme – still in power sector**

Looking forward

Has context changed?

- Is a stronger role of Commission acceptable?
- Does industry feel comfortable with EU caps?
- Can EU cap-setting accommodate material differences of member states?
- EU competences have not changed

Legal boundaries for EU cap-setting and allocation

→ **Subsidiarity (Art. 5 ECT):** For shared competencies, EU "shall take action … if objectives … cannot be sufficiently achieved by member states" for reasons

→ economies of scale

→ cross-border externalities (positive, negative)

→ **Proportionality**: need to identify most suitable – least interfering – instrument → hierarchy

- voluntary co-ordination
- (some) common rules and EU monitoring
- harmonised rules (EU-wide rules applied by all MS) and EU supervision
- centralisation (policy execution by EU)
- assigning competence to international organisation (e.g. UNFCCC sec)

Legitimate EU objectives

- **Avoid distortions in IM (cross-border externality)**
- **Environmental effectiveness – deflect industry pressure on MS to avoid race to the bottom (cross-border externality)**

[Analogy: competition policy; state aid, internal market rules; Euro]

How?

Breaking allocation down in its elements

Cap-setting (macro)

1. **Emissions projections**
2. **Emissions co-efficient applied to MS, sector, installation**

Allocation (micro)

3. **Allocation by EU rules and by EU, i.e. Commission [residual discretion with EU]**
4. **Allocation by member states (current)**

   a) by EU rules but application by member states [some residual discretion with MS, but convergence with model 3]

   b) for existing capacity but new capacity by EU!

   c) for both existing and new capacity

   [Some co-ordination]

Four Options (Sijm, 2007, adapted)

ETS sector is 28th member states

Option 1: centralisation

- Cap-setting and allocation by EU based on agreed methodology (Directive or Comitology)

Option 2: harmonisation

- Cap-setting by EU and allocation by MS
- Variant 1: member state allocation for existing and new capacity
- Variant 2: member state allocation for existing capacity and EU allocation for new capacity

Burden-sharing at EU level (as before)

Option 3: Present system improved

- Cap-setting by EU and allocation by MS
- Variant: member state allocation for existing capacity and EU allocation for new capacity

Option 4: Present system marginally improved

- Cap-setting by member states but based on agreed projections methodology (e.g. PRIMES) but no agreed emissions co-efficient; MS allocation
- Variant: member state allocation for existing capacity and EU allocation for new capacity

Initial analysis

Cap-setting

- **Agreeing on "objective" methodology for emissions projections is doable [PRIMES (default) or Agreed Methodology → see also LETS Update 2006]**
- **Setting emissions co-efficient (CCAP 2000)**

  1) Pro rata allocation of the cap to MS based on their share of the Community's baseline emissions for the trading sectors (Issues: Year? Impact on energy policy?)

  2) Pro rata allocation based on projections for 3rd phase (Issue: impact on energy policy), or

  3) Pro rata allocation based on benchmark emission rates for affected sectors.

Initial analysis (2)

Emissions co-efficient(s) or benchmark(s):

- developing benchmarks will take time
- may not be possible for all sectors
- EU-wide benchmarks (for existing capacity) and impact on security of supply/energy policy
- differentiation necessary (EU-15; EU-12 etc.) and special pleading will remain.

Result:

- More consistency in approach as Commission applies common methodology
- Overall outcome similar to current system if improved

Allocation

Member state allocation may reverse effects of EU cap-setting

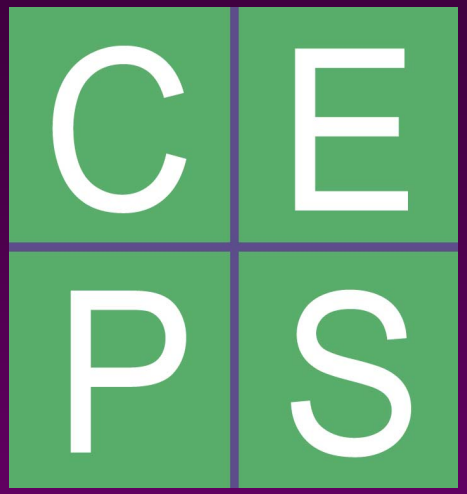
Some concluding thoughts

- **Agreeing on "objective" methodology for emissions projections is doable**
- **Agreeing on "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 at MS or for ETS sector)**

Some concluding thoughts (2)

- Current system improved by i) agreed methodology for emissions projections, ii) ETS emissions outside the burden-sharing agreement or better BSA, iii) some harmonisation on allocation (especially on new entrants/closures but also progress on benchmarks and agreement on auctioning) can make a difference.

- Key is application of Community co-efficient (or benchmark) for cap-setting (politically feasible if combined with special pleading).



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