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Production data and their updating for use in allocation rules

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Prologue

- This presentation discusses possible improvements of the current rules for free allocation regarding the use of historical or more recent production data
- I.e. “ex-ante” vs. “ex-post”
- It does *NOT* discuss other elements of the recent Ecofys paper on annually updating allocations (such as an allocation reserve or allocation for indirect emissions)

Prologue (2)

- This presentation does not discuss whether free allocation is the tool of choice for tackling the risk of CL.
- It is noticed that free allocation does not fully implement the "polluter pays principle" enshrined in Art. 191 TFEU.
- This presentation does not deal with cap setting. It is assumed that the cap will be sufficiently strict after 2020 for leading to GHG reductions in line with the 2°C goal.
- It assumes that a significant, ex-ante decided fraction of the cap will be earmarked for auctioning, i.e. some form of correction factor will be needed for free allocation.

Features of current allocation system

- **Ex-ante system** based on product benchmarks and fall-back approaches
- Designed to treat all participants as equal as possible
- Original 2008 proposal: Only one ex-post correction: New entrants (defined as greenfield plants)
- Some ex-post corrections were introduced during the political process of the EU ETS review
- Some complex rules should indeed be simplified (e.g. difference between linear factor and cross-sectoral correction factor)

Why do we discuss allocation rules?

There are claims that the current system is:

- Inviting for "optimisation" by operators (choice of baseline period, splitting installations…)
- Using historic data = data not representing actual production
- Complicated and insufficient regarding new entrant and closure rules
- Not sufficiently tackling the carbon leakage risk
- Complicated

Different CO_2 price signals

- Ex-ante:
  - Incentive for reducing production (same as for auctioning) – benefit from reduced tonnage productions, and additional production leads to higher CO_2 costs per unit
  - Therefore higher CO_2 cost pass through = desired effect for incentivizing behaviour change of consumers and innovation in downstream industries
- Ex-post:
  - Constant CO_2 costs per unit → no price signal for reducing production ("license to produce more")
  - No need to pass full costs to customers (only difference to BM) → good for reducing CL risk, but making ETS less efficient
  - Operators may be comfortable with allocation and delay investments, even if financial incentive is the same as for ex-ante

Special issue: Fall-back approaches

- Fall-backs are currently used by 75% of all sub-installations (30% of total 3rd phase allocation)
- If efficiency is improved, then in an ex-post system:
  - → Activity level for heat and other fall-back sub-installations decreases
  - → Allocation would decrease
  - → Such improvement would be penalised
  - → ETS with ex-post allocation is less efficient
- Ex-ante: no such wrong incentive – encourages efficiency equally for all types of sub-installations

→ Switch from an ex-ante system with few ex-post corrections to ex-post system with many ex-ante corrections desirable?

Practical issues of ex-post allocation: High uncertainty

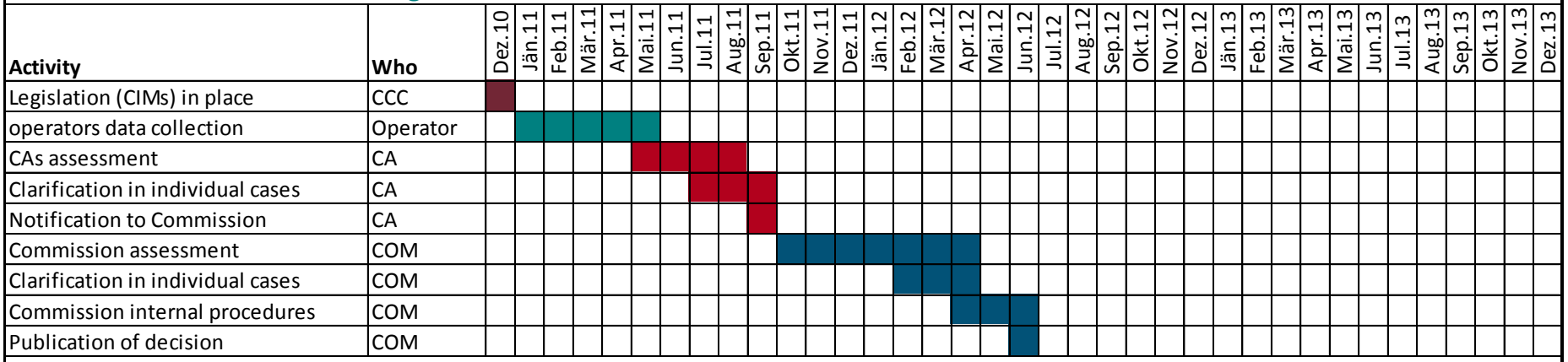
- For ensuring sufficient auctioning, a correction factor is needed. Because activity levels change annually, the factor needs to be calculated each year.
- Even if an installation produces the same amount every year, the allocation will be changing every year.
- An installation can't predict the amount of allocation for a year, because it depends on the activity level of *all other* installations in the system.
- If one sector increases production significantly, it takes away the allowances from other sectors.

Practical issues of ex-post allocation: Timing of the "Allocation cycle"

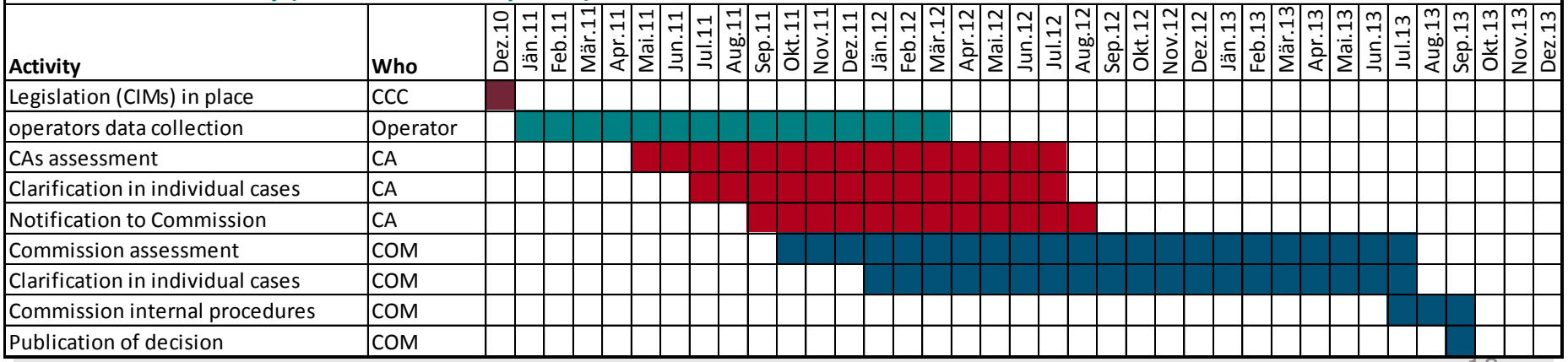
- Activities required:
  - Operator reports activity
  - CA checks / gathers feedback or corrections where necessary
  - CA notifies data to Commission
  - Commission performs checks / gathers feedback or corrections
  - Commission approves data
  - Commission calculates final allocations
  - CA allocates (incl. formal information for operators and Registry)
- In theory possible within one year after reporting:
  - In year y+2 correction of allocation for year y
- In practice very unlikely that all MS meet this schedule
  - More likely: Final allocation only 3 years later

NIMs experience: 33 months (expected: 18)

NIMs Process - Theoretical Timing



NIMs Process - Reality (with some assumptions)



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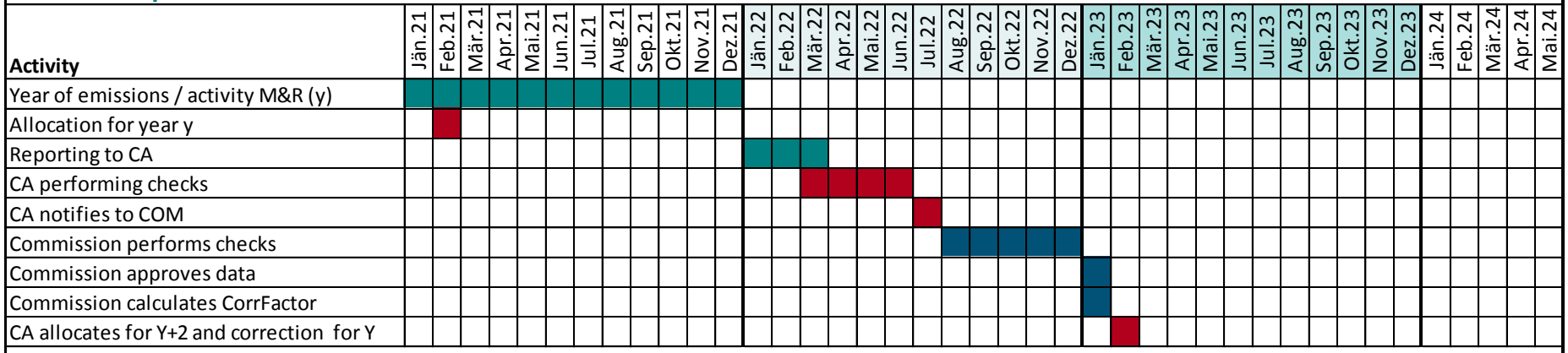
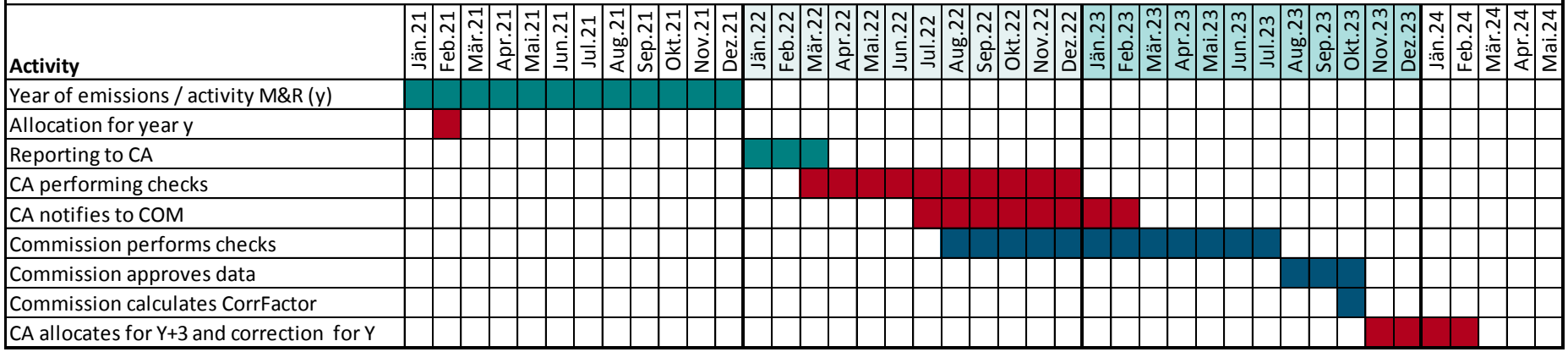
Practical issues of ex-post allocation: Timing

Possible ex-post allocation timetable



More realistic scenario



What can be realistically improved?

If free allocation continues after 2020 (2027):

- Create an ex-ante system with more recent data
  - instead of up to 15 years old (2005 → 2020) use most recent data every 3 or 4 years
  - Don't allow exceptions, but the same 3 or 4 years average for everybody (also solves confidentiality issue)
- Simplify: Discard elements like
  - difference between LinF and CSCF,
  - part. cessation and capacity reduction,…
- Simplify NE&C rules:
  - only one rule for greenfields (as "fast start support")
  - only one rule for closure
  - Install a small NER
- Provide EU wide harmonised MRV rules for activity data

Features of a good* allocation system

- Transparent, unambiguous
- Allows no optimization / gambling
- Feasible (timing, administrative costs)
- Giving long-term certainty
- Not distorting the CO_2 price signal
- Allows for reasonable auctioning revenues

** An allocation system is considered "good" if it helps achieving the ETS's goal AND has a chance to survive the political process for putting it in place*

Final remarks - What do we want?

	Ex-ante	Ex-post
ETS that delivers cost effective GHG reductions	yes	Less efficient
Reduced risk of Carbon Leakage	(yes)	(yes)
Administrative burden	manageable	burdensome
Certainty for investment decisions	high	low
Cost for MS / tax payers	(yes*)	(yes*)

→ Proposed system on the previous slide could be a good solution

*depends on ration auctioning / free allocation

Thanks for your attention!

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Disclaimer:
This presentation reflects the opinion of the author and not necessarily that of Umweltbundesamt.