Revision of the Emissions Trading Scheme Directive (ETS)
AFEP's position

*

This position paper focuses on the following points:

1. The revision process, as scheduled, should not pre-empt that of international negotiations and should not jeopardise the competitiveness of the EU.

2. The priority for the post-2012 period is to reach an agreement with the main emitting countries and develop a consistent Community system.

3. The revision of the ETS Directive should already include several significant improvements:
- **3.1.** In priority and in relation to the existing situation : allocation period and process, criteria should be harmonised, and the scope extended, etc.
- **3.2.** The worldwide convergence for the emissions markets should also be anticipated.

4. A regular dialogue between public authorities and companies throughout the revision process of the ETS Directive, as well as a thorough review of the PRIMES model and other criteria applied, are a prerequisite too.

*

1. The revision process should not pre-empt that of international negotiations and should not jeopardise the competitiveness of the EU

The European Commission is willing to position itself as a "pioneer" and to make the European system the "docking station" for other trading systems being developed, anticipating on international discussions that will only be launched at the end of this year.

The European Commission has already organised 4 meetings with all stakeholders in the 1st half of 2007 and a draft revision of the ETS Directive is due before the end of 2007.This process has the merit of favouring continuity as regards the value of allowances between the 2008-2012 period and the post-2012 period, with the co-decision process due to be completed by the end of 2009. However, it does not provide the openness that would ensure the fair participation by all emitting countries in the effort to lower emissions worldwide during the 2013-2020 period. It should therefore be made possible to update the directive to take into consideration new developments at global level.

In this regard, it is worth pointing out the major disadvantage of the current scheme, i.e. an operator whose specific emissions have worsened but who has experienced a significant decline in growth is favoured, whereas an operator whose specific emissions have improved but who has experienced strong growth is penalised. This scheme, based on absolute value emissions, is unattractive to the other main emitting countries, which would have a stronger motivation to improve their specific emissions (based upon units of production). It cripples growth in Europe and weakens the competitiveness of undertakings whose competitors do not have to respect the ETS constraint to minimise their greenhouse gas (GHG) emissions.

It is therefore advisable that the Community authorities proceeds with the common, harmonised allocation methods that were discussed but not finalised yet within the above mentioned stakeholders working groups. It appears crucial to keep working, inter alia, on a

comparative approach, on the basis of specific value objectives to be adapted according to appropriate criteria for sectors with sufficient homogeneity in their activities. It will be essential to determine how to take into account growth forecasts so as not to penalise companies which have improved their specific emissions but which have emitted more due to a higher than forecast level of activity. Appropriate mechanisms should be identified.

Taking into account major technological leaps (e.g. CO_2 capture and storage) should also be ensured in the draft directive. Adaptations during the period should also be made possible.

Section 2 of this paper outlines the importance of an international solution, then section 3 discusses the essential changes which need to be made to the directive pending this international solution, so that the competitiveness of European companies is better safeguarded. Finally, section 4 specifies the conditions to be met in order to achieve a realistic allocation of emission reduction targets between Member States with a view to 2020.

2. The priority for the post-2012 period is to reach an agreement with the main emitting countries and develop a consistent Community system

As recommended at the beginning of April 2007 by the preliminary report of the "Energy" commission, chaired by Mr Jean Syrota, set up in France to define energy policy with a view to 2050, the priority is to achieve a realistic agreement with the main greenhouse gas emitting countries and not with as many States as possible.

Indeed, it seems much more pragmatic in the first instance to reach an agreement with the main emitting countries (by way of reminder, in 2000 **10** States/groups of States emitted **73%** of greenhouse gases[1]), since bringing together a large number of actors risks delaying the signing of an agreement considerably. Moreover, forecasts indicate that, as from 2020, developing countries' emissions will exceed those of developed countries.

Therefore, it is advisable to pursue discussions beyond the European Union and, particularly in the context of the enlarged G8, to start seeking such an agreement as early as 2012. The objective is to adjust the Community system to the next worldwide extension of the GHG emissions management system.

[1] These are the United States (20%), the European Union and China (14% each), India and Russia (6% each), Japan (4%), Brazil (3%), Canada, Mexico and South Korea (2% each).

3. The revision of the ETS Directive should already include several significant improvements

3.1. In priority, and in relation to the existing situation : allocation period and process criteria, should be harmonised and the scope extended

Allocation methods must be harmonised and enable improved predictability
It seems advisable to extend the allocation period to approximately 10 years in order to stimulate reduction investments. With this in mind, AFEP supports the Commission's proposal, made during the third revision meeting, to select a period of 8 years (2013-2020), coinciding with Europe's objectives with a view to 2020.

In this context, and according to the allocation methodology, the possibility of mid-term adjustment of allocations should be studied in order to take into account major changes, both within and outside of the European Union. However, it will be advisable to specify appropriate mechanisms enabling possible adjustments without compromising environmental integrity. The current thinking in relation to absolute value allowances should not prevent this proposal from being analysed.

Companies are open to the possibility of analysing, together with the French and Community authorities, whether harmonised Community allocations are advisable for certain homogenous business sectors (e.g. refinery, iron and steel industry, cement, etc.), insofar as this would avoid distortions of competition within the Community. They consider that this could lead to alignment with worldwide sector-based draft agreements based on specific emissions. It would be advisable to analyse the envisaged methodologies closely, as well as the definition of the sectors and sub-sectors concerned (look for sectors which are as homogenous as possible).

In general terms, companies favour common calculating rules, provided that they reliably take into account forecast national data for specific emissions, as well as growth forecasts, past emissions, emissions per unit of GDP, per capita emissions, and the specific characteristics of the national energy mix. With this in mind, it seems preferable for the criteria presented in the current Annex III of the ETS Directive to be supplemented through the implementation of a common calculating rule.

As a result, it must be possible to envisage the coexistence of two allocation procedures, i.e. one at Community level for those major homogenous sectors that would accept it, and the other at the level of each Member State, for the other sectors. The allocation procedures must be harmonised in both cases.

Companies are open to the possibility of relying on a comparative approach long as the logic would be based on identifying a progress coefficient to be applied within a reasonable timeframe to the average performance observed. This approach should be envisaged specifically within a sector-based logic and could only be carried out if a ratio could be identified in a satisfactory manner by the members of the homogenous sector or sub-sector. The comparative approach should focus on performance, without distinguishing according to the nature of the technologies used. With this in mind, AFEP supports the European Commission's proposal made at the third revision group, to initiate a study during the second half of 2007 on the feasibility of the comparative approach within the framework of WG3 (working group including the Commission and the Member States). It would be advisable for this study to take into account the average performances observed at international level, particularly in those countries where the main competitors of European undertakings subject to quotas are based.

In general terms, allocation decisions should be taken as early as possible so as to stimulate investments. Ideally, it would be desirable for these allocation decisions to be determined 3 to 4 years before the start of the period. Taking into account the length of the co-decision

procedure, (if a draft is submitted by the Commission by the end of 2007), it is requested that allocation decisions be laid down at least 2 years in advance for the third period.

Common allocation rules must be based on recognised models and include national objectives with a view to 2020 established on the basis of a clear and recognised process

As has been mentioned in the framework of the consultation process with the European Commission, it is essential that all of the variables which will be used in the negotiations between States on burden sharing for 2020 are adopted in a transparent and concerted manner between the stakeholders. The process of defining national objectives with a view to 2020 should be exemplary in terms of dialogue and should not be hurried. It should also take into account the international context.

It is necessary for the constraints on undertakings under the ETS Directive for NAP3 to take into account the efforts already made by undertakings in the industrial and energy production sector (need for increased efforts for the other major fields of emissions), even if this requires taking into account data prior to 2005 (1st year of auditing).

Common calculating rules for the allocation should only be established following the agreement of all Member States as to the relevance of the calculation and the simulation models to be used. In particular, this concerns the PRIMES model and any other model envisaged by the European Commission, given that the use of the PRIMES data for the 2008-2012 allocations has appeared to be problematic (use of a long-term model for short-term decisions, use of CO_2 data when the model is designed to deal with energy issues, use of a single indicator). It appears fundamental at this stage for the PRIMES model to form the subject of comments and proposals by Member States, and ensure that they are actually taken into account in the context of updating it.

The use of auctions should be prohibited so long as competition distortions exist

As far as companies are concerned, it is not acceptable to envisage implementing generalised auctions so long as significant distortions of competition continue to exist between sectors and plants subject to the carbon constraint and sectors/plants not subject to this constraint.

A certain auction allocation could be envisaged for sectors not subject to such constraints and which, to date, have been able to pass on the additional cost of the CO_2 constraint in the price of their products. Economic analyses should be carried out in order to avoid that such auctions lead to prices soaring at a similar or higher level than in the 2005-2007 period for the customers of those firms subject to auctions It will also be advisable to resolve the issue of the harmonisation of auction procedures between Member States and the use of the income from these auctions. In those cases where these latter sectors present significant differences in terms of company size, it would not be advisable to use the auction allocation insofar as it would create disparities of access to the allowances. In other cases, it will be imperative to predetermine the procedures for using the income from the auctions, ensuring that it does not result in turn in distortions of competition between sectors and between Member States. In this regard, it is advisable to avoid the problems already encountered during previous allocations. A specific procedure to use the income for undertakings which are most exposed to competition should be analysed.

Enlargement to include N_2O from the chemical sector must be confirmed for the post-2012 period

At this stage, it is referred to the inclusion within the scope of the ETS Directive of N_2O emissions from the manufacturing processes for adipic acid, glyoxylic acid and nitric acid in the context of the chemical sector. It should be noted that these emissions should already be allowed via "opt-in" for France and the Netherlands for the 2008-2012 period and that it would be advisable to generalise their inclusion to avoid distortions of competition.

The link with the draft directive concerning the inclusion of aviation should be clarified
On 20 December 2006, the European Commission adopted a draft directive aiming to include aviation in the ETS Directive from 2011 for flights within the Community, and from 2012 for flights departing from or arriving in the European Union. The aim of this draft is to amend the current ETS Directive (2003/87/EC). Companies would like to know how this process is going to be carried out insofar as it is laid down that this directive (2003/87/EC) is subject to revision in the form of a draft directive at the end of 2007. Will the provisions of the draft directive on aviation in fact be included in the new revised draft ETS Directive?

Extending the directive to new sectors post-2012 should only be envisaged with the greatest caution
The first meeting on the revision of the directive, dedicated to the scope, was an opportunity to state that an extension of the scope could be envisaged for road and sea freight. AFEP would like to indicate that any extension should only be envisaged following a detailed impact study confirming that there is no risk of soaring quotas prices for those sectors already subject to the directive and which have to face up to international competition. In this regard, it appears essential for impact studies to be carried out with the participation of all of the actors subject to the directive, who will be the first to face the consequences of such a development.

Harmonising the treatment of new entrants, closures and transfers of allowances in case a production is transfered I
AFEP supports the need to harmonise the treatment of entrants and closures as it considers that distortions of treatment exist throughout the Union (e.g. closures from the Netherlands retain their allowances, whereas in the other States they lose them). For entrants, expected GHG emission performances should be higher than those of incumbents.

Companies are in favour of maintaining allowances in production transfers from one plant to another, provided that the original plant is closed. They stress that the transfer of allowances without loss should be enabled for two situations not covered to date:

- In the case of a production transfer within the same country: make it possible to transfer allowances if the transfer is taking place between two different operators which are subsidiaries of the same group (in France the problem is solved in the specific case where the operator is the same),
- In the case of a production transfer from one country to another: make it possible to transfer allowances when the operator is the same and when the operators are different, but are subsidiaries of the same group.

For this reason, they would like a specific clause to be included in the ETS Directive and systematically transposed, if possible even with retroactive effect, during the 2008-2012 period.

Flexibility mechanisms (CDM/JI) and domestic offset projects should play a greater role. The supplementarity clause should be re-examined
Before the end of 2007, the Commission should announce the continued use of CDM credits post-2012, so as to stimulate continued investment in CDM projects during the 2007-2012 period.

Companies confirm the advisability of using CDM credits from forest planting and land reallocation, provided that the monitoring and auditing system used is recognised to be reliable.

It would be advisable to continue to promote the simplification of administrative requirements relating to the approval of CDM/JI projects and to favour "programmatic" projects subject to standardised methodologies. The advisability of revising the supplementarity rule[2], for example

[2] This rule specifies that at least 50% of Member States' efforts within the European Union must be carried out in their national territories.

by lowering the percentage of reduction efforts which can be performed outside of the national territory, should be assessed by the authorities together with the undertakings. In fact, this rule may appear to be too restrictive given the need to develop CDMs and given that the greenhouse effect is global in nature. It is important to reduce emissions wherever they occur.

The increased use of CDMs appears to be essential since, according to the directive's impact study on the inclusion of aviation in the ETS Directive, these CDMs are essential in order to avoid soaring CO_2 prices. In fact, these CDM credits represent an important source of liquidity to cope with the risk of allowances becoming scarce taking into account emission reduction requirements with a view to 2020. Therefore, it seems once more from this observation that a change in the supplementarity rule appears necessary. Instructions regarding CDMs should be more accessible and rapid to facilitate their use without, however, compromising as regards monitoring requirements.

In technical terms, it is advisable for the ETS Directive to confirm that the maximum percentage of usable CDM/JI credits applies throughout the period and not for each year during the period.

Section 3.2 of this paper indicates how the use of CDM credits would enable the various "regional" systems to prepare for global convergence.

AFEP would also like the post-2012 period to be an opportunity to enable the generalisation of national projects according to the experiments carried out during the 2008-2012 period.

These changes would make it possible to bring about greater dynamism among those countries which have taken little action to date regarding the greenhouse effect.

Simplified monitoring, reporting and auditing rules must be maintained for small plants. Other provisions may change if appropriate

The priority for manufacturers is to ensure that monitoring, reporting and auditing provisions for small plants are as uncumbersome and least costly as possible, compared to the level of emissions. Companies note with satisfaction that the new European guidelines for monitoring and reporting emissions for the 2008-2012 period were indeed endorsed by the Community climate change committee on 29 July 2006.

Companies consider that the possible exclusion of *public* combustion plants alone exceeding 20 MWth from the scope of the directive is totally unjustified given competition rules. Furthermore, it goes against the States' exemplary approaches. A proposal such as this would send out a conflicting message to all private operators, of whom efforts would continue to be required.

The current French monitoring, reporting and auditing system is considered to be satisfactory. It is not advisable to increase its complexity and remoteness from the "installation level" by harmonising these plans at Community level. Companies are willing to maintain the close relationship with the local supervisory authorities. For the same reason, nor are the companies in favour of an harmonisation of declaration methods at Community level.

It is advisable to avoid any further reporting constraint on manufacturers, both as regards the nature of the information and the regularity of transmission (annual transmission is already extremely cumbersome and costly).

AFEP supports implementing equivalent accreditations and harmonising accreditation control at Community level. However, the companies have reservations about the relevance of "simplified" accreditation for small single plants, insofar as monitoring, reporting and auditing procedures would already be simplified for these small plants.

Companies are in favour of harmonising the types of reservations issued by auditors in their reports in order to standardise the acceptance or rejection of declarations. However, this work will require some investment over time.

In terms of respect for compliance, companies would like the Commission to ensure, in the framework of the power conferred on it, that applicable penalties are applied in all Member States, ensuring the absence of exemptions.

Companies reject the idea of setting up a Community register for the monitoring, auditing, compliance and penalties phases, as this would eventually replace the direct relationship between the operator and the local supervisory authority, which the companies consider to be a priority and in line with the principle of subsidiarity.

AFEP believes that the proposal to set up an exchange forum rapidly between the Member States, the Commission and the auditors, as suggested in the second meeting on the revision of the directive, appears pertinent to promote the convergence of provisions and practices and develop revision proposals. This forum should also include representatives of the undertakings subject to the directive.

It does not appear relevant to transform the guidelines on monitoring, reporting and auditing into a prescriptive document, as the forum's observations can be integrated continuously.

Certain data management rules must be respected to a greater extent and other related provisions should change

Companies consider that the data from the CITL (Community Independent Transaction Log) are very difficult to access. They are not presented clearly and it seems very complicated to extract data concerning undertakings and obtain consolidated annual data easily. The reliability of some information is also questionable. Finally, ethical rules concerning the use of the data are missing. In this regard, the deadlines for the publication of information on GHG emissions at Community level should be respected to a greater extent. We must avoid what happened in both 2006 and 2007 when the information on the emissions data for year "n-1" emissions was made public, in part, ahead of the official deadline of 15 May of year "n".

The Community Regulation on national registers should evolve to enable the funding of the operation of the registers, not only by actors subject to the ETS Directive, but also by actors only performing allowance transactions (it is not possible to make them participate today). This measure is desired to achieve a fairer treatment.

A prevention and management mechanism in the event of CO_2 prices on the market soaring excessively should be analysed, taking into account the price volatility already observed

It would be appropriate to be able to analyse the issue of the advisability of regulating the market and its constituent elements. Companies point out that the most structuring elements with an impact on ***CO_2*** prices will be first of all the level of allocations, second the aviation integration procedures and, finally, the flow of JI/CDM credits which manufacturers subject to the ETS Directive will be able to use.

The issue of a market regulation mechanism must therefore be tackled as a complementary measure with the view to limiting exaggerated fluctuations in CO_2 prices constituting a risk for industry in Europe. At Community level, the most important thing would therefore be to achieve a common identification of the consequences of an exaggerated fluctuation in CO_2 prices, both upwards and downwards, for certain sectors which are particularly sensitive given their cost structure or their exposure to competitors free of any carbon constraint. It would also be necessary to agree on appropriate responses such as, for example, the possibility to set the discharge penalty at an acceptable level.

The competitive handicap of European undertakings should be better taken into account while waiting for an agreement with the main emitting States

The relevance of an EU cross border adjustment system, in the absence of an agreement with the other main emitting states, should be dealt with in the context of the revision. At the very least, the issue of the impact of distortions of competition for common business sectors between undertakings subject to the ETS and those not subject to it should not be overlooked. This point was raised in the context of the 1st report by the High Level Group on environment, energy and competitiveness of June 2006. In a letter of November 2006, Commissioner Verheugen asked the President of the European Commission to set up a working group on this specific subject (same comment for the "guidelines" on the compatibility between long-term energy contracts and competition rules, which the European Commission was asked for in June 2007, in the framework of the HLG report of June 2006). Moreover, the Spring Environment Council also asked the European Commission to examine this aspect via the issue of "carbon leakages".

3.2. The worldwide convergence of the emissions markets should also be anticipated

Progressive alignment of markets is desired

We must seek to converge the various "carbon markets", but this process can only be carried out very gradually. In fact, to date, several market experiments outside of the European Union are being developed, particularly in the United States, Canada, Japan, Norway and Switzerland, but they use extremely varied operating procedures.

In particular, not all of these markets are mandatory, impose the same emission reduction constraints for identical sectors, have the same requirement levels in terms of monitoring and auditing or set identical penalties in the event of failure to respect objectives. As a result, CO_2 credit prices vary considerably.

Companies support the recommendations made by the Commission during the consultation on the revision of the directive, and consider that a direct link could be envisaged between the various systems solely if the above characteristics become common.

With this in mind, a three-stage convergence process is proposed based on the common use of CDM credits:

- **Stage 1:** enable each major regional system (e.g. US, European and Asian) to use CDM credits according to a process defined in the framework of an agreement yet to be drafted. The more each regional system imposes a significant reduction constraint in the framework of obligations, the more project credits it could use. To achieve this, it would be necessary to enable the supplementarity clause to be relaxed (need to carry out at least 50% of reduction efforts in the national territory), which could lead a country, for example, to make 60% of its reductions outside of the national territory. This means strengthening the governance mechanism of the project mechanisms. This initial stage would make it possible to assess how prices would evolve within each system thanks to this flexibility, without taking the risk of direct connection.

- **Stage 2**: in high-emitting emerging countries, impose the changeover from "conventional" CDMs to "programmatic" CDMs enabling measures to be generalised at the level of each State. It would then be advisable to analyse the change in the characteristics of the systems, particularly the emission reduction and penalties constraint. Depending on this analysis, links could then be initiated between the systems.

- **Stage 3:** bring high-emitting emerging countries which have implemented "programmatic" CDMs within the group of constrained actors. Continue to link up regional systems according to the convergence of the characteristics.

The need to update the directive

It appears appropriate to provide for a clause in the revised directive reviewing the development of the various systems, which would lead to a report being drafted in 2010 containing recommendations regarding a possible change in the procedures for linking the ETS Directive with the other systems. This report would take stock of the criteria to be used and would analyse the markets' level of convergence in terms of CO_2 reduction constraints and price signals.

Moreover, it seems useful for the revised directive to include an adjustment clause in the event of major changes, other than those already laid down through force majeure, particularly in the event of a new agreement being entered into between emitting countries affecting the 2013-2020 period. This clause would enable an analysis of the directive to be initiated so as to adapt it according to the new characteristics of the agreement. It would make it possible to speed up convergence between the various markets.

4. A regular dialogue between public authorities and companies throughout the revision process of the ETS Directive, as well as a thorough review of the PRIMES model and other criteria applied, are a prerequisite too

Companies consider it essential to continue exchanges with national and Community authorities throughout the legislative procedure due to lead to the final adoption of the revised ETS Directive.

This co-operation is also essential in relation to the assessment of the PRIMES model, the other criteria used in the context of NAP3 allocations (particularly in the case of a comparative approach, auctions, etc.) and calculating the burden sharing for 2020.

*