



Department
of Energy &
Climate Change

EU Emissions Trading System - Carbon leakage and free allocation rules

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Overview

- UK position on carbon leakage
- Experience of free allocation rules – Phases II and III
- Looking ahead to Phase IV



UK position

- Strongly committed to the EU ETS as a key mechanism to achieve emission reduction goals in a cost-effective manner
- Recognise the risk of carbon leakage and support the free allocation of allowances to mitigate this risk
- Evidence suggests that a small number of sectors are likely to be at high risk of carbon leakage; free allocation should be focused on these sectors, to ensure they are appropriately protected
- Proportion of allowances auctioned should increase over time



Free allocation rules – Phases II and III



Key changes from Phase II

Improvements

- Harmonisation of free allocation rules across the EU
- Free allocation focused on industrial sectors at risk of carbon leakage, rather than all EU ETS installations
- Introduction of partial cessation rules to reduce over-allocation
- Benchmarks applied to incentivise emissions reductions
- State aid available to protect against indirect costs
- NER allowances cannot be pre-reserved (although application process has become more complex)

Concerns

- Complex rules to calculate allocations, with potential for delay and uncertainty
- Significant data requirement, in particular for determining NIMs applications and capacity changes



Experience of Phase III provisions

Administrative experience (UK)

- 2014 allowances issued ahead of 28 February deadline
- Capacity changes and NER applications processed successfully
- Compensation payments made to over 50 companies for indirect costs

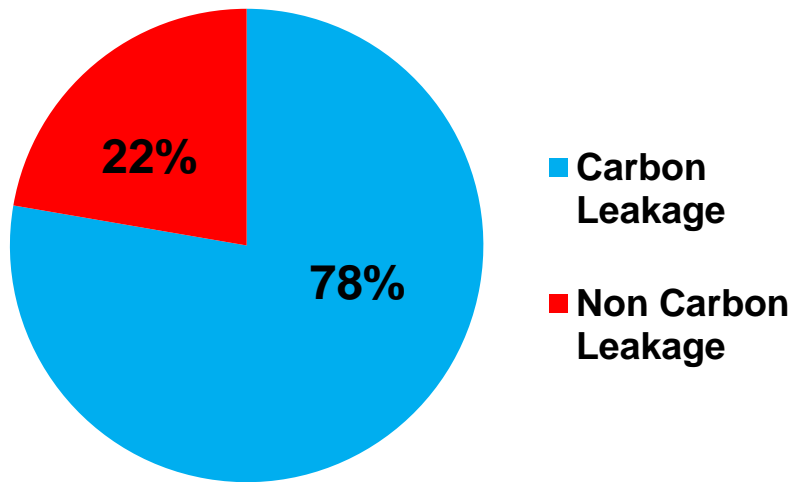
Issues

- Delay to finalising free allocation figures, due to complexity of system and administrative effort required from both operators and competent authorities
- 63% of industrial sectors, covering around 78% of industrial emissions, deemed at risk of carbon leakage
- Application of cross sectoral correction factor

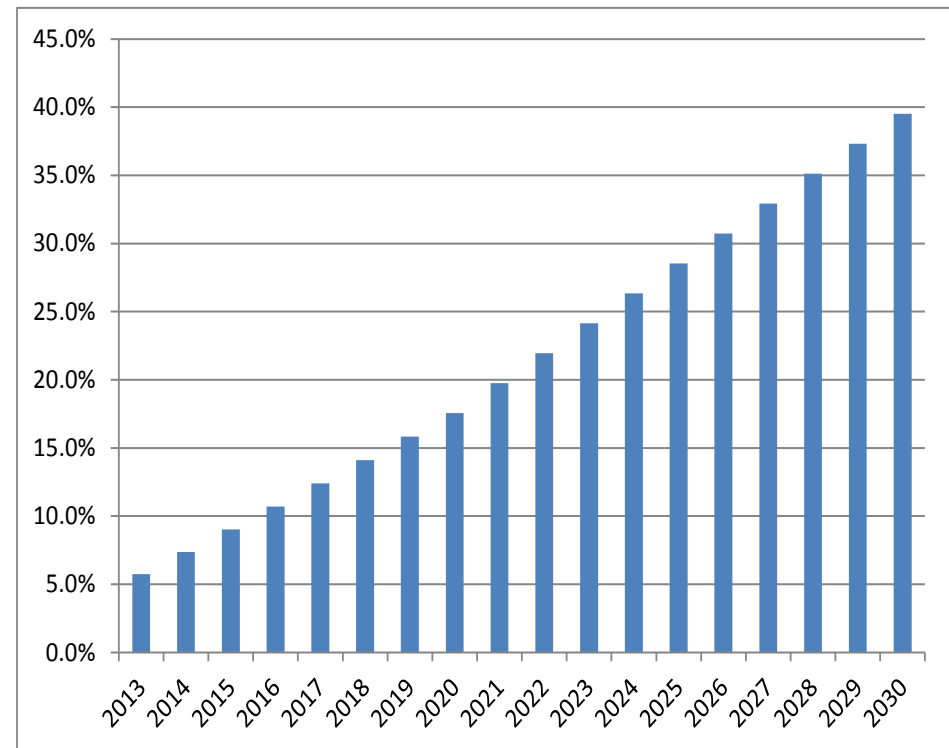


****NB illustrative example – not UK Government policy****

Cross-sectoral correction factor



Percentage of industrial emissions under draft 2015-19 carbon leakage list, based on 2013 emissions figures.



Indicative trajectory of current cross sectoral correction factor; continuation of current rules and consistent with 40% target for 2030 (2.2% linear reduction factor post 2020)



Looking ahead to Phase IV



Vivid Economics-Ecofys report

Purpose

- Review of evidence of carbon leakage as a result of the EU ETS
- Investigation of risk of carbon leakage for a selection of industrial sectors at various, hypothetical carbon prices
- Assessment of current rules for the assessment and mitigation of risk of carbon leakage

Key findings

- No robust evidence of carbon leakage to date as a result of the EU ETS
- In the absence of mitigation measures, some sectors may be significantly impacted by higher carbon prices. However the extent of future risk varies greatly between sectors
- Criteria for assessing carbon leakage could be improved, and trade intensity-only criterion should be re-considered
- While not perfect, free allocation is an effective, feasible and internationally compatible mitigation measure
- Border Carbon Adjustments may be theoretically attractive, but there are significant concerns regarding their feasibility and administrative costs, and the potential for legal challenge or retaliatory trade measures



NB illustrative example – not UK Government policy

Impact of focusing free allocation

Scenario ¹	Total costs/GVA	Trade intensity	Other	Qualifying sectors ²	Description
Long	5-10%	10%	Qualitative	153	Proposed 2015-19 list
	30%				
		30%			
Medium	5-10%	10%		22	Trade intensity only and qualitative criteria removed
	30%				
Short	10%	10%		10	Total cost/GVA threshold increased
	30%				

Change to CSCF rules for analysis

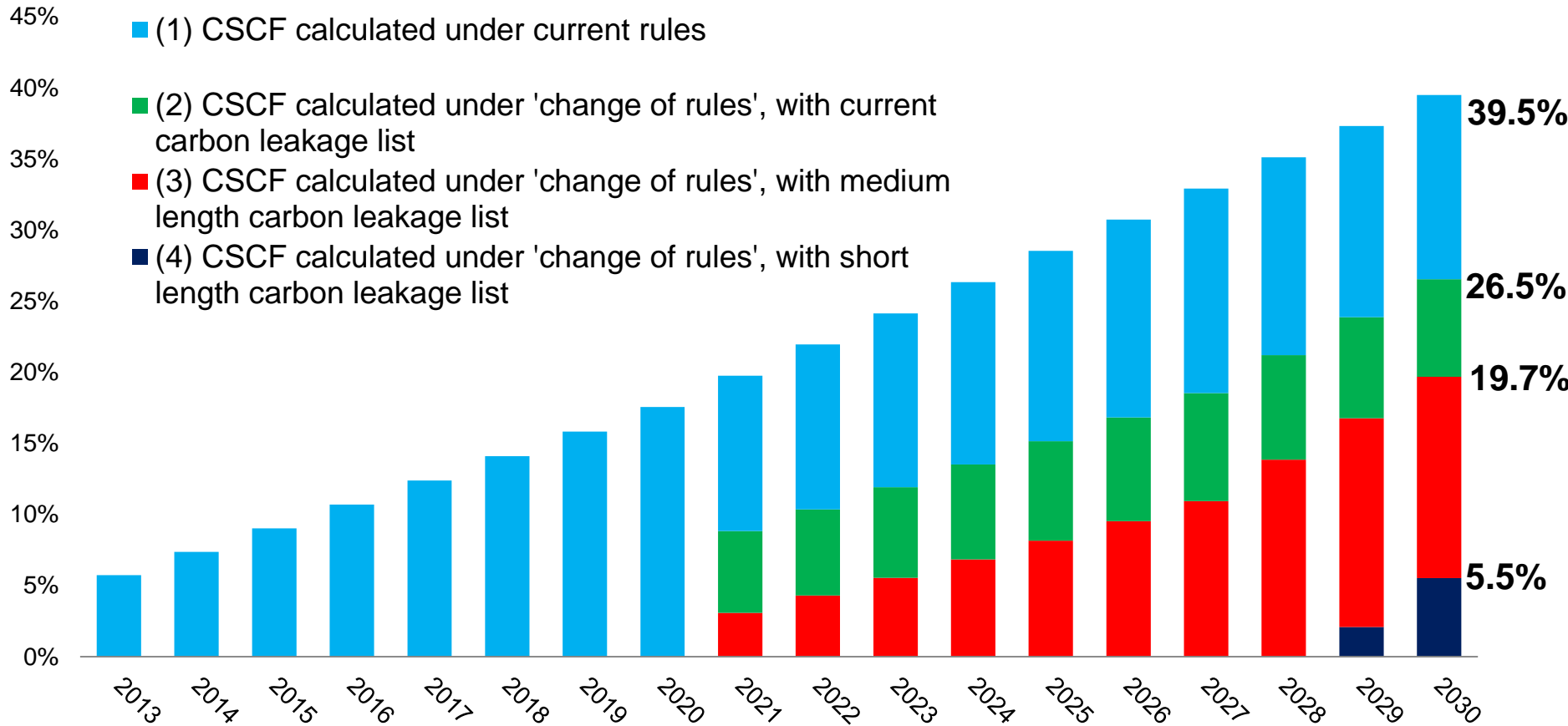
- **Current rules** – preliminary free allocation assumes all industrial installations – both carbon leakage and non-carbon leakage – receive free allocation at 100% of benchmark. Valid approximation now but increasingly inaccurate as non-carbon leakage allocation declines over time
- **Change in analysis for post-2020 period** – update calculation so the preliminary free allocation figures take into account declining free allocation for non-carbon leakage sectors (30% in 2020 reducing to 0% in 2027)

¹Sectors qualifying below NACE-4 level have been considered ‘non-carbon leakage’ in all scenarios, due to limited data availability

²Based on draft 2015-19 carbon leakage list



Impact of focusing free allocation



^Analysis undertaken by UK Department of Energy and Climate Change.

*Post 2020, all scenarios assume an ETS cap consistent with a 40% traded sector target for 2030, which is assumed to equate to a 2.2% Linear Reduction Factor for calculating the CSCF.



Other options

- Tiered free allocation?
- Greater flexibility in allocation rules?
- Update benchmarks?
- Improve criteria for assessment of carbon leakage risk?



Conclusions

- The free allocation system broadly works, but there is scope for improvement
- Existing rules will not provide sectors at highest risk with appropriate protection in Phase IV
- There are inherent trade-offs in reform:
 - Between number of protected sectors and level of protection for each
 - Between proportion of cap used for free allocation and for auctioning
- Reform must be based on evidence and analysis, to ensure carbon leakage provisions are sustainable, maintain an incentive for emission reduction and protect sectors at highest risk



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Thank you