

## **REVISION OF THE EUROPEAN TRADING SCHEME**

### **BUSINESS VIEWS**

### **EXECUTIVE SUMMARY**

Created in 1992, Entreprises pour l'Environnement (EpE) is an association of large companies which have gathered to progress together in integrating environment in the strategy and daily management. Its members are companies from various sectors from industry and services, including energy intensive industries, energy producers, financial services providers, among others (see attached). EpE serves as a think tank for its members, whose experience is brought as the main feed for thoughts.

Climate change has been one of the major topics for many years, and EpE has been the first circle where market-based solutions have been discussed in France. In 2002, EpE initiated the creation of AERES ([www.aeres-asso.org](http://www.aeres-asso.org)), a group of industrial companies who made voluntary reduction commitments on the six greenhouse gases of the Kyoto protocol and have been since measuring, verifying and publishing how they stick to this commitment (see annual report on the web-site).

In addition, many of the EpE members are directly active on the ETS carbon market, whether as financial actors or compliance users, power producer or energy-intensive industrial international groups, and the association has dedicated significant work to the analysis of the first years of operation of this market as well as discussion on future commitments and/or processes/approaches

The attached notes result from this work. They encompass:

Notes on:

- allocation mechanisms;
- predictability for regulators and clear visibility to industry's investments;
- auctioning process;
- the need for a market authority on the European carbon market.

This executive summary provides a summary of this material. In many instances it presents a choice that can only be made by political decision. The purpose of this paper is to express views on such political choices stakes and consequences.

### 1. Allocation mechanisms

- 1.1. Various impacts according to sector: allocations can be made for free or at a price, and this price may be market-based (auction), fixed, or limited (min and / or ceiling price) by public authorities.
- 1.2. Quotas can be allocated according to grandfathering or to benchmarking principles, and for a longer or shorter period;
- 1.3. The conclusions of our detailed analysis are that the two most efficient systems are:
  - 1.3.1. if a sector is subject to competition with outsiders (whether foreign or from parallel sectors), **allocations are economically and environmentally efficient when made for free according to benchmarking principles and quotas should be technology-neutral**; however, if a new installation replaces an existing one, the remaining allocation of the latter should be **transferable** to the new one.
  - 1.3.2. If a sector is in a position where it can pass the cost of quotas through the price to the end-user, then **the economically and environmentally efficient allocation system is auctioning**.
- 1.4. **Linking with sectoral agreements:** in case of a sector that would have agreed upon a sector agreement leading to emissions reduction of a similar magnitude as the ETS, a special treatment could be adopted in order to encourage worldwide approaches of reduction efforts.
- 1.5. **Harmonisation of allocation methods across Europe:** such harmonisation would be useful to avoid competition distortions between European countries. This should not however go as far as setting up a global European cap for emissions subject to ETS; the sharing of national emissions objectives between industry, energy and other sectors should be left to member states so as to encourage maximum energy efficiency progress and policies.

### 2. Duration of allocation periods for free allocations

- 2.1. In the absence of a complete knowledge of available technologies and future available technologies as well as their level of implementation (such as Carbone Capture and Storage), **the longer the allocation period is, the more efficient the decisions** leading to produce a given amount of a given product with minimum emissions. Few economic modelling studies available today attempted to determine what amount allowances should be dedicated to industry and power production as opposed to those forecast for housing, agriculture and transportation over a long period of time. It is geographically diversified and has to be optimized using international policy and measures.
- 2.2. Between the difficulty of an allocation compatible with the life duration of an industrial facility (30-50 years) and the inconveniency of a short allocation period, **a viable method could be with a long-term allocation, i.e. an allocation with a duration**

**of 20 years, with a first 10-year period fixed and the second semi-flexible; this allocation for the second period could be adjusted according to significant changes incoming during the first 10-year period.** The allocations would then be known approximately 10 to 20 years in advance, allowing for industrial decision-making processes and enabling revisiting according to “cas de force majeure”. We well noticed that first term should be 2020 and that the banking, according to the existing directive, would be now allowed and maintained within each of the following periods.

### 3. Auctioning

- 3.1. **Auctioning could be the general mode of allocating quotas to such sectors which can pass the cost of quotas to their consumers.** If any distortion of competition, it should be limited to favouring GES-efficient processes. Industrials from other sectors subject to international competition and new entrants could also participate to the auctioning processes to acquire additional quotas. This difference in treatment is subject to legal verification.
- 3.2. **Various auctioning models could be used : ascending-bid and sealed-bid auction;** in addition **variables prices mechanisms** could occurs such as uniform-price or pay-your-bid auction , **volumes** as well **frequency** and finally **the perimeter** on which it is applying is also critical for the market mechanism.
- 3.3. A **European auctioning system** seems preferable to national systems within European boundaries, as most actors now manage their quotas on a European basis.
- 3.4. **Periodical auction (one or a few a year)** seems acceptable. Quantities to be auctioned would then be determined on a European basis, on a frequency to be determined, after taking account of the national free allocation plans as described here above, as well as status of potential national reserves. Based on experience of the French AERES, which has allowed an analysis of the variations in emissions for a wide range of sectors, the quantities could be auctioned taking into account the meteorological conditions of the previous year instead of being determined for the same 10 year period as the free allocations.
- 3.5. **The wise use of the proceeds** of such auctions is a precondition to the acceptability of the system according to the chosen allocations methodology. Various possibilities can be envisaged, ranging from funding for emissions reduction investments to distribution of the proceeds to the same sectors according to different criteria (for example according to final production, regardless of the technology). The competition distortions of any such mechanism have to be clarified, as well as its impact on product prices.
- 3.6. **Implementation of auctioning has to avoid any undesirable impact on the market price** as identified with previous allocation methodology and information publications.

#### 4. For a market independent authority

**4.1. What sort of market authority?** Most markets in the world have a regulator in the sense of an authority having access to information on the market actors and transactions, and able to provide analysis of the evolutions and verification that there is no manipulation of the market through unfair use of information, for example. It seems useful that the European carbon market be equipped with such an **independent authority**. The market authority could also be in charge of the yearly determination of the amount of quotas to be auctioned, within a policy determined by political authorities.

**4.2. A role in linking mechanisms:** this authority will be all the more needed when linking with other markets will have to be put in place, indeed as soon as other markets will exist. Such an authority should be among other things able to entertain discussions on “currency exchange rates” between the prices of the quotas on the various other markets. These “technical” fittings could also be discussed in an appropriate joint committee.

#### Conclusions

The above summaries are based on the experience from the first period, as well as discussions among EpE members for future approaches. This contribution should be viewed as a contribution to the European dialogue on this topic, and not as formal recommendations.

EpE members and team are of course at the disposal of the Commission or other contributors to the revision process to detail or discuss any part or all of these notes.