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CHAIRMAN'S BACKGROUND DOCUMENT N° 2

Subject: Allocation methodologies and recognition of early action

Part 1: Principles

2. Allocation methodologies and their practical implementation should be simple, fair and transparent. By “fair” is meant allocation methodologies that do not create systematic competitive distortions. Furthermore, allocation methodologies should be environmentally effective, which means that they should encourage early action and not reward past inaction.
 - 2.1 Industry and Green NGOs argue that early action is to be rewarded, or at least, not disadvantaged. The Commission's services fully agree with this objective. Policy-makers certainly do not want to create a void in which actors refrain from taking further action for fear that it would be against their best interests.
 - 2.2 An initial allocation¹ is a necessary pre-requisite for emissions trading to begin. The different methodologies for this allocation have differing distributional impacts, as have any other measures to reduce emissions. It is generally accepted that “early movers” who have unilaterally reduced their emissions should not be penalised.

Part 2: Methodologies

- 2.3 Of the various methodologies, there are basically two categories. Allowances can either be granted free, or those who want them can pay for them. The latter case is generally referred to as “auctioning”. The funds raised by Member States could be recycled so as to keep the revenue impact neutral, but there would have to be distributional imbalances if recycling was not to amount to simple refunding of amounts paid for allowances. Some oppose auctioning for two reasons. First, auctioning presupposes payment for something that has until now been “free”. However, this reflects that greenhouse gas emissions from industrialised countries have become a limited resource, the limitation deriving from the Kyoto Protocol's commitments and the limited capacity of the atmosphere to soak up greenhouse

¹ The word “allowances” is used as a substitute for both “permits” and “credits”. It is to be noted that “baseline and credit” type trading assumes the free allocation of the emissions allowed by the baseline.

gases. One way of “softening” the impacts of auctioning may be to phase auctioning in over time and not to require up-front payment. Second, industry suspects that revenues will not, in practice, be recycled. Ensuring revenue neutrality by Member States is something that the Commission cannot ensure. However, revenue recycling will always take place, as, one way or another, governments always spend what they receive in revenues. The question is, rather, how revenues are spent. From an environmental perspective, it is desirable that revenues arising from the auctioning of allowances finance additional environmental measures or investments.

- 2.4 Auctioning, on the other hand, does avoid the problem of who gets what in a free allocation. Buyers who value the allowances most will get them, and everyone has equal access to them. Early action is rewarded by the fact that those who have reduced their emissions need to buy fewer allowances than they would otherwise have done. Transparency is more easily ensured. Furthermore, new entrants can buy their way into the market on the same basis as incumbents, assuming that auctioning takes place with sufficient regularity and provided that the market is of a size sufficient to avoid the exercising of “market power” by a cash-rich incumbent. Competitiveness may, however, be impaired if auctioning is superimposed on other climate change measures, such as energy taxation.
- 2.5 Allocation for free is generally referred to as “grandfathering”. Grandfathering is usually justified on grounds of compensating for or avoiding the creation of “stranded assets”, that is to say, investments made before the existence of, or change in, the regulatory framework. This is an argument that loses its validity over time. It is, perhaps, a reason for requiring “new entrants” to buy their way into a market, because they cannot claim to be unaware of the new regulatory framework when they enter the market. Grandfathering is may also be justified in terms of maintaining the competitiveness of export-industries in energy-intensive products.
- 2.6 Grandfathering can be done on the basis of historical emissions, taking a given year or the average over a number of years as the reference period. In such a case, agreement has to be reached on a common reference period, or the method for determining such a period. The more recent the base period, the less “early action” is taken into account. The further back the base period, the greater the possibility of a windfall benefit for action taken for non-climate reasons, the harder it is to reconstruct in a consistent manner historical emissions for a large number of sources, and the more sources will be concerned by the new entrants issue. A 1990 baseline, for example, would be much more favourable for certain companies than for others. Indeed, the choice of baseline period will have significant distributional effects. One way of countering this – but inevitably compromising simplicity – may be to allow companies to choose their base period within certain parameters, although policy-makers may then have to employ “ratcheting” to reach the desired pre-determined outcome.
- 2.7 Alternatively, “grandfathering” can be done on the basis of specific performance standards, or benchmarking (i.e. output related components are taken into account in relation to a reference period). Benchmarking, in rewarding those who emit comparatively less per unit of output, favours companies that take “early action”. Due to technological progress, benchmarking is likely to favour companies (and countries) with newer industrial installations compared to companies (and

countries) with older installations. This has implications in the Community in the context of the relatively recent economic development of some Member States. The same benchmarking methodology can be used for new entrants. However, the establishment of benchmarks will be a complicated process, specific for each industrial sector (and possibly sub-sector). Products and costs structures within industrial sectors and sub-sectors or not homogenous between Member States. It is also difficult to ensure the same level of stringency of benchmarks for different sectors. Such complexities are not conducive to an early start for emissions trading.

- 2.8 Grandfathering can also comprise a combination of historical emissions and benchmarking. Indeed such combination is likely if allocations are made on the basis of historical emissions to incumbents and where new entrants (i.e. those starting to operate after the reference period but before the emissions trading commences) are still to be receive allocations for free. Grandfathering is not necessarily an “easy” option. The environmental effort, both in the case of historical allocation or benchmarking depends entirely upon the level at which objectives are set.

Part 3 Perspectives and conclusions

- 2.9 Combinations can be made of auctioning and “grandfathering”. One option often suggested is to start with an auctioned element, and to allow this to increase over time. Given that the “stranded assets” argumentation loses its validity over time, we expect to see a progressive evolution towards auctioning. Auctioning some of the allowances would allow new entrants to be confident of being able to acquire a sufficient number of allowances in order to operate.
- 2.10 Conclusion: On allocation methodologies, all methods of allocation have potential advantages and disadvantages. The free allocation method that is probably most favourable to early actors, namely “grandfathering” with benchmarks, is more complex than other methods. Consequently, a mixture of allocation methods may be the most practical way forward in terms of reaching consensus. Furthermore, a progressive evolution towards auctioning is expected over the longer-term. There will have to be trade-offs between simplicity, transparency and equity.