

Position of Verband der Chemischen Industrie e. V. (VCI) on the Continuation and Further Development of the European Emissions Trading Scheme

Communication from the Commission: Building a global carbon market
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Responsible resource management for fossil energy sources, aimed to limit anthropogenic emissions of greenhouse gases, will be a major challenge in energy and environmental policies of the years to come. In this context, it will be decisive to find solutions and instruments that come up to climate policy targets where their systems and structures are concerned, without threatening Europe as an industry location in comparison with global competitors. To this extent we welcome the basic idea of emissions trading to implement climate measures where they make most sense economically.

If brought in an adequate concrete shape, emissions trading – as a potential instrument under the Kyoto Protocol – is an economically efficient and thus useful system for limiting greenhouse gas emissions.

However, the EU Emissions Trading Scheme (EU ETS), implemented since 1 January 2005, has displayed some serious shortcomings in the initial two years of its pilot phase. These problems need to be remedied so that emissions trading can have the desired effects. In particular, a stronger focus will have to be given on the global aspect of the emissions issue.

In this position paper the German chemical industry association Verband der Chemischen Industrie e. V. (VCI) wants to give some important input for the further development of the EU ETS. The association VCI will continue to actively and constructively contribute to the improvement of the existing scheme, with the goal of making emissions trading in the long run – also beyond 2012 – an instrument that is effective and efficient both in environmental and economic policies.

I. Decisive points of the review process

VCI thinks that the review process should not be limited to questions addressed in the Commission Communication. The review should also cover the following central points:

- **Climate protection must go global**

The German chemical industry is committed to sustainable climate protection and lowered its energy-related carbon dioxide emissions by over 30% in the period from 1990 to 2002. Simultaneously, global carbon dioxide emissions continued to rise from 1990 by 6 billion tons to a total of 27 billion tons in 2005. This global issue can be tackled only by joint action, at least of all major emitters worldwide. The go-it-alone strategy pursued so far by the EU, where "internalised costs" of greenhouse gas emissions are borne solely by European companies, causes competitive

disadvantages for European industry vis-à-vis competitors on the world market. The reason for these competitive disadvantages is the cost of emissions trading, because – in the case of the chemical industry – this cost cannot be passed on due to competitive pressure. Therefore, it is of fundamental importance in the continuation and further development of international climate measures to involve all major emitters (such as e.g. the USA, China, Brazil and India). This can be done both by directly expanding the EU ETS to companies in those regions and by linking various regional approaches with each other. But it must be ensured that the cost of global climate protection be included in the production costs in all countries in a similar way, as this is done within the EU ETS. Otherwise incentives will persist (and additionally increase with further EU climate measures) to relocate productions to exactly those countries that make only few or no climate protection efforts.

An offensive should be taken when advocating this view also in the now beginning post-Kyoto discussions. It must be made quite clear soon in what form the emissions trading scheme, and especially the applicability of project-based mechanisms (JI/CDM), will continue after 2012. Here, CDM measures are particularly important, because at present they constitute the only operational starting point for climate protection that is truly linked globally: Only in combination with CDM measures, in an undistorted economic competitive relation to measures within EU emissions trading, can EU ETS come close to an efficient instrument, in the meaning of global climate protection. Consequently, any limitations in the implementing and contributing of CDM measures under the EU ETS run counter to the goal of economically efficient global climate protection. The use of project-based mechanisms in the EU ETS is a significant element for the global effect of this currently still regional trading scheme and, therefore, should be possible in future without any limitations. This is the only way for the principle behind the emissions trading scheme to unfold its desired impact.

- **Preferably benchmarks should be used in the prerequisite harmonisation of allocation rules.**

Experiences from the first trading period in the EU ETS and from the notification of national allocation plans for the second trading period highlight the need for a further harmonisation of allocation methods.

In the free-of-charge allocation, a system based on benchmarks must become the most important allocation method of the future, because this gives due consideration to the idea of producing as efficiently as possible (as opposed to foregoing economic activities). Already now, this is implemented or planned accordingly in some Member States. Especially for energy production installations and other largely homogeneous products, it makes sense to determine EU-wide, fuel-specific benchmarks. However, determining uniform benchmarks is difficult where products and production processes cannot be compared with each other. Different benchmarks at national levels must be avoided in order not to cause distortions of competition.

By contrast, the introduction of uniform, fuel-independent benchmarks for all fossil energy sources in electricity production encourages emission reductions by way of a simple fuel-switch, favouring mainly natural gas. With a stronger dependence on natural gas, this would run counter to the political goal of a balanced fuel mix – bound to result also in a stronger dependence on countries exporting natural gas and in

rising natural gas prices, further adversely affecting the global competitiveness especially of energy-intensive industries in the EU.

Furthermore, in a European scheme the quantities of allocations to installation operators must not depend on country-specific reduction targets.

- **Economic impacts of emissions trading must become more predictable**

Investments in new installations, in expanding capacities of existing installations or in modernisation measures presuppose a certain degree of planning security. This fact was realised in Germany, with long-term decisions being made for an allocation reflecting real needs in the first trading period. After this approach had been accepted by the EU Commission in the first trading period and was successfully put into practice, such legislation was banned for the second trading period.

This lack of planning security makes investments in new, more efficient and low-emission installations much more difficult. This stands in contrast to the idea behind emissions trading, i.e. reducing carbon dioxide emissions through improved installation technology. Therefore, uniform rules regarding framework conditions must be laid down as early as possible - also for post-2012, because only then can most investments bear fruit. Extending the respective trading periods or a higher permissibility in rules – accepted at EU level – between trading periods can make useful starting points for achieving more planning security. So long as decisive political factors influencing emissions trading are known only for a period of 5 years, the price of EU CO₂ certificates (EU-Allowances - EUA) cannot come up to the claim of giving reliable price signals for reductions of climate gas emissions. Instead, this price largely reflects short-term differential costs with relocations of productions to countries outside Europe.

- **A solution must be found to the electricity price issue**

The German chemical industry's first practical experiences with the new trading scheme show that emissions trading has developed a massive influence on electricity prices in Europe. Now it is undeniable that the scheme, in its present form in Germany and in other EU Member States with liberalised electricity markets, has led to a situation where certificates allocated free-of-charge are included – at their market price - in electricity prices. This is an inherent feature of the emissions trading scheme in its currently practised form. The lack of competition in electricity markets of many Member States further intensifies this effect – whilst the influence of emissions trading becomes obvious very directly in markets with comparatively intense competition, such as e.g. the United Kingdom. This practice results in massive energy price increases in the two-digit billion range, which can be no longer borne by industrial and private consumers in Europe. VCI presented a proposal how to solve this problem in a manner adequate for the scheme.

VCI Benchmark Model:

Under the existing emissions trading scheme, electricity producers have the choice of either using certificates for electricity production or of selling certificates. As has been done so far, this opportunity can and is included in electricity production costs, driving up prices ("windfall profits").

For this reason, the EU Emissions Trading Directive must be concretely shaped in such a way that there is no direct price-driving effect for electricity prices. To this end, the free allocation of emission certificates based on benchmarks should be linked directly to the production of electricity. Thus a drop in electricity production no longer opens up the possibility of selling certificates allocated free-of-charge at their market price, because they must be returned. Then their value can be no longer included in electricity price calculation as alternative earnings. Conversely, for production increases the installation concerned must be granted additional free certificates, based on fuel-dependent benchmarks.

Therefore, VCI proposes for electricity production installations an allocation based on the incentive of fuel-specific benchmarks, with allocation quantities being adapted retroactively, according to higher or lower production. To prevent diverging interpretations by the Member States, the admissibility of adapting allocations should be expressly included in the Directive. Such adaptations have not only the advantage of helping avoid windfall profits; they can also contribute to an altogether fairer allocation of emission certificates, e.g. by preventing simple fuel-changeovers without efficiency increases or "rewards" for closing installations.

- **Taking into account of physical-technical possibilities**

Emissions trading must not cause productions in Europe to be reduced, abandoned or relocated to sites outside the European Union. All three alternatives involve considerable disadvantages in economic and labour market politics that run counter to the Lisbon goal. Therefore, reduction targets in emissions trading must be ambitious, but they must be also realistic enough in such a way that improvements in installation technology and efficiency increases are really achievable. For example, it is in line with the basic idea of EU emissions trading to let installation operators decide whether they want to buy additional certificates or bring about technical improvements.

Reduction targets must consider both physical reduction limits and technical feasibility (e.g. based on Best Available Techniques – BAT). With a CO₂ reduction target of 20 to 30%, a considerably scarcity of certificates is emerging for the post-Kyoto period. Then at the latest, certificates will be no longer available in sufficient quantities to ensure for all installations an allocation, at least based on BAT. Equally impacted will be new investments coming up to BAT.

But where it is impossible to achieve targets even with BAT, emissions trading has a "penalising effect" for engaging in production activities.

- **Putting the instrument mix to the test**

Besides emissions trading, the chemical industry falls under further legislations with similar goals, intended to reduce greenhouse gas emissions. The concurrence of emissions trading with the promotion of renewable energies and energy taxes results in high total financial burdens that adversely affect the competitiveness of the concerned companies. The EU's instrument mix for climate protection should be scrutinised as to this cumulation of burdens, attuning them to each other.

II. Detailed comments on issues addressed in the Commission Communication COM(2006)676

- **Inclusion of other sectors and gases**

Regarding included greenhouse gases, the scope should be limited, also in future, exclusively to carbon dioxide (CO₂). It is unlikely that an inclusion of further greenhouse gases – in proportion to the additional cost and workload involved (e.g. in monitoring and validation) – will bring any significant benefits toward emissions reduction. Moreover, it must not be forgotten that the EU has developed, under regulatory law, a proposal for limiting so-called F-gases. Simultaneously regulating F-gases and including them in the emissions trading scheme makes no sense.

Further parts of industry should be included only after international harmonisation has really taken place and major competitors are subject to the same conditions globally. Any inclusion of further sectors, such as private households and transport, must be examined with due consideration being given to their respective framework conditions. In no case must an inclusion further drive up prices in the existing trading scheme.

An optional expansion of the system by the Member States would stand in contradiction to the Commission's harmonisation efforts, causing distortions of competition inside Europe.

- **Small installations**

The scope of the Directive should be limited by a threshold criterion of 50,000 tons of CO₂ emissions per year.

The complementary introduction of a threshold based on emission volume is useful, because – under the current scheme – a significant number of installations fall in the scope of the Directive, irrespective of that they cause only low emissions. In Germany the majority of currently covered installations (ca. 1,200 out of a total of 1,800) emit under 50,000 tons of CO₂ per year. These installations have a share of less than 4% in the total emission volume within the German emissions trading system. The administrative effort – both for companies and public authorities – due to the present inclusion of these installations is out of proportion to the achievable benefit (reduction of greenhouse gas emissions). Introducing a threshold criterion, in the form of an annual minimum emission volume, would considerably ease the administrative burden, without any negative impacts on climate policy.

- **Carbon capture and storage**

In future, CSS technology will enable a reduction of CO₂ releases into the atmosphere. But with the current state of technology, CO₂ separation causes efficiency losses for the concerned installation. This can impact supply security. Further regulatory law prescribing investment in CCS technology, alongside an application of the emissions trading scheme, is unacceptable. This would contradict the basic idea underlying emissions trading, i.e. those who have the necessary emission certificates are entitled to emit CO₂ volumes covered.

- **Emission reduction projects within the Community**

With the adoption of the so-called "Linking Directive"¹ the EU laid the foundation for the use of emission credits from project-based mechanisms (JI and CDM) in emissions trading. With this step, the Commission takes up the guiding idea that emissions should be reduced where this is economically most efficient and can be done at favourable cost. But with national project measures not falling in the scope of emissions trading, this rule is broken. Up until now, the flexible mechanisms JI and CDM do not apply for such projects within the Community, so that there is no incentive for emission reductions. For this reason, a further development of the JI mechanism - from which recognition of emission reductions achieved in Community projects ensues – is welcomed. The recognition of Community projects (national and EU-internal compensatory projects, respectively) can open up further potential for emission reductions at favourable cost.

- **Auctioning**

CO₂ emissions trading, in its present form, leads to a situation where certificates allocated free-of-charge are included in electricity prices at their market price. Electricity producers include fictitious costs in electricity price formation, bringing so-called "windfall profits". Resulting electricity price increases considerably threaten the international competitiveness of energy-intensive industries. These costs cannot be passed on, because prices for products of these industries form in global or, at least, supraregional markets.

Auctioning emission certificates is no solution to the described inclusion of fictitious costs in price formation. The growing use of auctions causes more bureaucracy and, consequently, rising costs. Moreover, fictitious costs become real costs for consumers, quasi cementing high electricity prices. Altogether, auctioning is more of a burden than a relief for energy-intensive industries. Therefore, from the viewpoint of the energy-intensive chemical industry, the allocation of emission certificates to all participants in emissions trading must be made fully free-of-charge, also in future.

- **New entrants**

Free and sufficient allocations to all new installations must be ensured. Adequate initial allocations for new entrants help maintain growth impulses and make investment in Europe attractive, safeguarding jobs and employment.

- **Closing of installations**

Emissions trading must not provide incentives for relocating productions abroad and/or for closing installations. This means that installations which, de facto, no longer produce or which significantly reduce production – and, consequently, do not need certificates to cover emissions – must not be allowed to keep certificates, either. Otherwise, remaining certificates would have the character of a "reward" for closing

¹ Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004 amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms, OJ L338/18 of 13.11.2004.

installations. This can be counteracted with the VCI's Benchmark Model (for details, see page 4).

- **Periodic review mechanism**

The emissions trading scheme is far from optimal in its shape and functioning. It can be assumed that also in the further course of developments, e.g. in the transition from the first to the second trading period, further weak points of the scheme will emerge that cannot be examined in the present review process. National and EU decisions alone on NAP II give rise to yet more problems. To be able to make the necessary corrections also in future, the proposal of periodic reviews with open results is supported.