The Alliance of Energy Intensive Industries (AEII)

29 March 2011

<u>EU ETS Allocation Rules for the third trading period</u>

The Alliance of Energy Intensive Industries (AEII) urges the European Commission and Member States to bring the Guidance Documents on allocation in line with the draft Commission Decision and with the EU ETS Directive

The Alliance urges the European Commission and Member States to change important points of the allocation rules in the draft Guidance Documents to ensure that competitiveness is least affected and sustainable economic growth is not unduly hampered or even blocked while respecting a <u>correctly</u> calculated total cap for industry.

We therefore call on the European Commission, and especially Vice-President Tajani and Commissioners Hedegaard and Oettinger, to act on the following commitment [1]:

> *"An explicit and thorough **'competitiveness proofing' of new legislation** will be undertaken. The impact on competitiveness of all policy proposals will be properly analysed and taken into account."*

This competitiveness proofing has been carried out for the draft Commission Decision on Allocation Rules for the third trading period 2013-2020. However, it has not yet been done for the emerging Guidance Documents on Benchmarks and Allocation Rules, derived from the draft Commission Decision.

The Alliance has identified serious issues, which it believes to be at odds with preserving competitiveness and promoting sustainable growth:

- One problem is the lack of clarity about the calculation of the industry cap, which in a wrong interpretation may lead to an unjustified too early application of the cross-sectoral correction factor. This problem is addressed in a separate Alliance paper.
- In the Guidance Documents, as they emerge, we see conflicts with the draft Commission Decision and, in some cases, even with the EU ETS Directive.

[1] COM website *"Industrial competitiveness, Europe 2020 flagship: An Industrial Policy for the Globalisation Era"*

A detailed analysis of our main problems with the draft Guidance Documents are outlined in the **appendix:**

'Competitiveness proofing' of the emerging Guidance Documents on Allocation

The Alliance would like to stress that most of the problems presented in the appendix are the result of the 'ex-ante' historical allocation by the European Commission. Industry has always advocated against 'ex ante' historical allocation. This 'ex-ante' carries the risk, not only of over-allocation and incentivising carbon leakage, but also of severe under-allocation, preventing investments and sustainable growth in Europe, a growth needed for jobs and innovation.

We are convinced that allocation on an 'ex-ante' frozen, outdated historical production going back to 2005 for the allocation until 2020 is no longer appropriate and that an alternative approach solving the fundamental problems is both feasible and legally possible. Therefore the production factor must be re-evaluated, at least in the next revision of the ETS Directive. In fact, one major reason why no other major country in the world seriously considers to copy the EU ETS is this flawed 'ex-ante' approach. It is this fundamental characteristic which makes the EU ETS so complicated, counterproductive and unattractive.

Appendix:

'Competitiveness proofing' of the emerging Guidance Documents on Allocation

In the present assessment we observe the following problems, which are, we feel, at odds with preserving competitiveness and promoting efficient sustainable growth:

1. **Avoiding a no-growth policy: Adequate flexibility in determining new and added capacity needed for recent capacity extensions (2005-June 2011)**

   The allocation for recent capacity extensions (2005-June 2011) will be based on the added capacity and the installation's historical utilisation rate or another relevant utilisation factor. To ensure an adequate level of allocation, it is essential that the added capacity is defined accurately. However, determining the added capacity according to the suggested rules may result in an unrepresentative low capacity level.

   This will be the case if the added capacity could not be fully utilised during the period of 6 months after start-up ("start of normal operation") which determines the added capacity, e.g. due to a lack of market demand (e.g. a seasonal demand for a specific product occurs later than 6 months after start-up or start-up in or just before the financial crisis), or technical problems (which often do occur esp. in the initial phase) or if a necessary extension of a downstream or upstream plant which still had or still has to be realised.

   The suggested rules in the Guidance Document are particularly unfair and unjustified – as we will show below – for recent capacity extensions where the start-up of the extension has been in the past before any of these rules were known. A too low allocation for added capacity because of flawed administrative rules has surely no legal basis in the Directive and would be against the Europe 2020 Strategy.

   Therefore, we request:

   - For the 90 day period in Guidance Document n° 2, version v10.1 of 14 March 2011 (page 37) the additional requirement in the 90-day period of "aggregated" activity level be dropped: according to the draft Commission Decision (*"the approved first day of a continuous 90-day period, ..., during which the installation operates at least at 40% of the capacity that the equipment is designed to accommodate taking into account, where appropriate, the **installation-specific operating conditions**"*) if there are days in which the new capacity is not used for 40%, there is not yet a continuous 90-day period. This should be mentioned in the Guidance Document.
   - The technical change made in the past shall be incrementally eligible as technical change until the capacity the equipment was designed to accommodate taking into account, where appropriate, the sub-installation specific operating conditions is reached. In this case, the operator would have to demonstrate that the increase in capacity is still linked to the initial physical change.
   - Industry clearly opposes to calculation methods which may in practice not fully reflect the added capacity [2].

[2] In the example of Guidance Document n° 2, page 42: if the capacity increases from 1200 to 1800 but the production after the capacity increase only became 1200, the Guidance Document stipulates that 2/3 (1200/1800 x 1200 = 800) of this production would have taken place in the old capacity and 1/3 (600/1200 x 1200 = 400) in the added capacity. In (the normal business and accounting) reality the added capacity is not utilised at all.

- A more flexible application, in case the new capacity could only be partly utilised, must be allowed: The draft Commission Decision stipulates that experimental verification is allowed (Art. 7(3)) *"where it is not possible to determine the initial capacity according to point (a) ..."* [(a): average of the 2 highest monthly production volumes between 2005-2008] while Guidance Document n° 2, version v10.1 (page 26-27) limits experimental verification to cases when production data is missing (less than 2 months (!) production in baseline period 2005-2008, or records were lost).
- It must be accepted that if the actual realised production after the capacity increase is equal or lower than the capacity before the capacity change, the added capacity is disregarded. At a higher production than the old capacity, the old capacity is fully utilised. The formulas (Guidance n° 2, page 41) must be adapted accordingly.
- Industry has proposed that the operator should be entitled to determine the new or added capacity:
  - On the basis of experimental verification, as is foreseen for product benchmark sub-installations (Art. 7(3)) in case of lack of historical data, which should also be acknowledged for cases of "*installation-specific operating conditions*" in which an unrepresentative too low capacity would result because of reasons as mentioned above, or
  - On the basis of the average of two selected months, or broken months (e.g. 15 January – 15 February) deemed representative by the operator for the new capacity on the basis of independently verified project documentation about the new capacity (before or after "start of normal operation") multiplied with 12. Each month is calculated to 720 hours (30 days, e.g. February production x 30/28).

The legal justification for these 2 rules is that there is ***no causality link*** [3] between the added capacity and the realised production in case the added capacity could not be fully utilised, e.g. due to a lack of market demand (e.g. start-up in or just before the financial crisis), or technical problems (which often do occur) or if a necessary extension of a downstream or upstream plant which still had or today still has to be realised.

The two alternatives above are then also open for added or new capacities started up after 1 January 2005 and for installations that have been temporarily shut down during the reference period, because the shorter period could make median 2005-2008 or median 2009-2010 (because of the crisis) unrepresentative.

In addition, the Alliance cannot agree with the following text followed with an example of a ceramics producer (Guidance Document n° 2, version v10.1 page 38):
*"If a physical change prior to 1 July 2011 leads to higher production volumes of the sub-installation concerned after 30 June 2011, this so-called spare capacity will in principle be eligible for further allocation as a new entrant due to a significant extension **provided** that the conditions under step 1 are fulfilled, namely that the operator can show that **another physical change** has been made to the operation"*.

This interpretation demanding a second investment (how significant, another 10%?) is not reasonable, it is against the Guidance Document itself (the physical change of step 1

[3] If after a capacity increase the production becomes lower instead of higher, a *lower* allocation is excluded in the Guidance Document (page 34) because *"there needs to be a **causality link** between the physical change(s) and the change in capacity."*

has already been done), and also against the draft Commission Decision (Art. 3(i) (ii) "*the sub-installation **can** be operated at a capacity that is at least 10% higher ...*".

This means that the actual higher operation can for good reasons also be realised later, giving further support to our proposal.

2. **Avoiding a no-growth policy: Adequate flexibility in determining new and added capacity needed for future capacity extensions (after June 2011)**
   The same problems may occur with significant capacity extensions after 30 June 2011. These extensions fall under the rules for new entrants.

   With the same justification, the Alliance insists that the 2 rules as mentioned above also need to be possible for significant capacity extensions after 30 June 2011.

3. **Avoiding a no-growth policy: Capacity extensions of product benchmark and fallback benchmark sub-installations must be acknowledged at physical level**
   The draft EU Guidance Documents on allocation define a "sub-installation" as the addition of all (physical) manufacturing plants falling under the same (product or fallback) benchmark within an "installation" (permit site). The text of Guidance Document (n° 2, version v10.1 of 14 March 2011) mentions (page 8): *"The boundaries of a sub-installation are **not** necessarily defined by the boundaries of physical process units"*.

   However, the draft Commission Decision (Art. 6) clearly states "*For the **purposes** of this Decision ... sub-installations **shall** correspond, to the extent possible, to **physical parts** of the installation"*. In addition, concerning access to the new entrants' reserve (NER) the draft Commission Decision explicitly mentions: *"... to avoid distortions of competition ... to ensure equal treatment of installations between Member States*" (recital 35).

   According to the draft Commission Decision, the thresholds for access to the NER, to qualify as "significant capacity extension", are applied at the level of the "sub-installation".

   Therefore we propose that for the purpose of significant capacity extensions the operator should be allowed to choose as a basis for the allocation rules the relevant level of disaggregation and if appropriate use the physical sub-installation as the basis. Then distortions of competition between plants subject to different permitting systems in the EU are avoided.

   We refer to situations with for example 2 or 3 crackers, 2 or 3 ammonia plants or many heat-consuming benchmark sub-installations are subject to one GHG emission permit whereas in most cases such manufacturing plants have a separate own permit.

   In these cases normal growth of plants would become virtually impossible because the thresholds (10% capacity increase or 50,000 EUAs and 5% capacity increase) to get allowances for an expansion will become hardly achievable in practice (the addition leads to relatively huge sub-installations).
   However in case of partial cessation of operations, the reference must not be the physical unit but the in the installation as a whole as foreseen in article 10a paragraph of the revised EU ETS Directive: *"The Commission shall, as part of the measures adopted under paragraph 1, include measures for defining **installations** that partially cease to*

operate or significantly reduce their capacity, and measures for adapting, as appropriate, the level of free allocations given to them accordingly."

4. **Avoiding a no-growth policy: The Guidance Documents must not discriminate between so-called ETS and non-ETS heat-consuming benchmark sub-installations**
   The "physical change" should be defined as a change of at least one of the physical parts of the "installation" as a whole, which – according to the definition in the ETS Directive (Art. 3 e) – includes *"any other directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution"*. Thus, a physical change of the heat-producing sub-installation should not be the only possible valid requirement, but a physical change of the "non-ETS" heat consumer (which is part of the "installation" according to the above definition) should also be acknowledged.

   Increased heat demand can often be met without a capacity increase of the heat-producing sub-installation due to existing spare capacity (boilers and CHP (combined heat and power)) on a site and especially because new spare capacity will be created by energy and CO_2 efficiency investments, according to the very objective of the EU ETS, Art. 1, and Art.10a(1) in particular: "*the measures shall ensure that allocation gives incentives for reductions in GHG emissions and energy efficient techniques*".

   The EU ETS Directive aims at an EU-wide harmonised allocation and clearly states (recital 23): "*They* [the allocation rules] *should also avoid undue distortions of competition on the markets for electricity and heating and cooling supplied to industrial installations. They should further avoid undue distortions between industrial activities carried out in installations operated by a single operator and production in outsourced installations*".

   The requested equal treatment of non-ETS with ETS heat consumers is of utmost importance for a large part of the heat consumers in the EU ETS, namely in situations with "narrow" permit systems such as in e.g. Germany and UK.

5. **Avoiding a no-growth policy: Significant capacity extensions (and reductions) of one plant also need to include the allocation of upstream and downstream plants**
   A significant capacity extension of a downstream plant (e.g. polymers, fertilisers, hot rolling capacity in the steel industry) will require an increase of production in the upstream plants (for polymers the cracker, for fertilisers the nitric acid and ammonia plant, for steel the hot metal plant). However, while the downstream plant meets the criteria to qualify as a significant capacity extension, the upstream plant may not if sufficient spare capacity is available. Then the upstream plant would not get any additional allocation.

   The upstream – and in a reverse situation the downstream – chain effects of a significant capacity extension must be acknowledged in the allocation rules. Not considering these chain effects would be contrary to "the fresh approach" in the Commission paper on an Integrated Industrial Policy to reinforce the value chains of European Industry [4].

[4] Page 4: "The whole value and supply chain must be considered, from access to energy and raw materials to after-sale services and the recycling of materials. And some parts of this chain are bound to be outside Europe; hence it is necessary for all industries to have a 'globalisation reflex'."

6. **Preserving competitiveness: Physical sub-installations of large integrated complex sites within one GHG emission permit must be able to choose different baseline periods and different median years**

   A uniform approach on a large integrated site with one GHG permit would ignore different economic circumstances of completely different activities in the past, often with different owners per physical sub-installation. The result would be competitive distortions between plants operating under different permitting practices in the EU.

   Imposing for such large integrated sites a site-wide approach with the same years for HAL (Historical Activity Level) for all physical sub-installations is therefore in conflict with the aim to harmonise allocation and avoid discrimination, in particular with regard to outsourced production, as mandate by Recital 23 of the revised EU ETS directive. This is also explicitly referred to in the draft Commission Decision on Allocation Rules: to avoid competitive distortions and ensure equal treatment of installations across Member States (Recital 35) and to take account of different permitting practices (Recital 36).

7. **Preserving competitiveness: Consistent heat allocation in all cases**

   Allocation for heat will be done to:

   - The heat consumer, in case the heat consumer is "ETS".
   - The heat producer, in case the heat consumer is "non-ETS".

   Guidance Document n° 6 (v11, 11 March 2011, page 6) correctly states that no distinction is made between heat from different sources including heat as by-product of a benchmarked process, with the only exceptions being (1) heat from nitric acid, (2) heat produced by a non-ETS plant and (3) heat use for electricity production.
   It must be ensured that also the data collection template includes all possibilities, including heat export by product benchmark sub-installations.

8. **Preserving competitiveness: Allocation for waste gases, i.e. the emissions above the natural gas part must be to the producer instead of the consumer and process emissions must be acknowledged as such**

   Guidance document n° 8 (waste gases and process emissions sub-installation) mentions that the allocation for the part of the emissions above the natural gas level of waste gases in sub-installations outside the boundary of a product benchmark will be to the consumer (chapter 4.1, page 10). However, we believe that Guidance Document n° 8 contains a misunderstanding about allocation to the consumer, a wrong implementation of the principles referred to in art.3(h) of the draft Decision for what concerns the process emissions, is not complete (still need for rework), and as we understand it contains unintended omissions.

   Allocation of allowances for waste gases to the producer, such as rightly happens for product benchmark sub-installations like e.g. the steel industry, is the same as allocation of allowances for heat to the heat consumer. In the case the generation of heat or electricity is outsourced, giving the allowances pertaining to process emission part of the waste gases (i.e. CO_2 emissions relating to waste gases minus natural gas equivalent part) to the waste gases user will place the waste gases producer in a lock-in situation as the waste gases user could switch to natural gas and keep the allowances (the same

would have happened if the allocation pertaining to heat was given to the heat producer). In the case of allocation of allowances for heat to the heat-consumer the heat consumer can easily change heat supplier. Similarly, the waste gas producer can change waste gas customer, if the generation of heat or electricity is outsourced.

The allocation for heat from burning waste gases (the "natural gas part") will be to the heat consumer in case of an ETS heat consumer as mentioned in 4.1, but it seems forgotten that for a non-ETS heat consumer the allocation will be to the heat producer.
The allocation to the heat consumer should be only for the "natural gas part" (4.2 and 4.3) according to the heat benchmark as is probably meant, but it seems forgotten that the part of the process emissions above the natural gas part shall be included (chapter 4.2 and 4.3) and allocated to the waste gas producer, as we propose.

As regards the necessary acknowledgment of process emissions as such, the paragraph relating to process emissions of type b mentioned in the 28th of March version of draft Guidance 8 should be reconsidered in-depth since the new wording might lead to granting no allowance at all to – notably – the ferro-alloys industry though the latter was recognized as an industry exposed to carbon leakage.

9. Preserving competitiveness: Confidentiality of commercially sensitive data

Production volumes, energy efficiency and types and quantities of feedstock are often commercially sensitive data. Exchange of information between companies of such data is forbidden under anti-trust legislation. These data are needed for product, heat, fuel and process emissions benchmark sub-installations. Therefore the Guidance Documents should specify that such data can be treated confidentially along the lines as stipulated in the letter of the Commission (by Mrs. Slingenberg) of 15 February 2010 concerning confidentially of data when the "top 10%" benchmarks were established.

10. Environmental effectiveness: Abatement measures in so-called fallback sub-installations must not lead to reduced allocation

Contrary to the advice from industry, the draft Commission Decision defines capacity and HAL (Historical Activity Level) of the fallback benchmark sub-installations in terms of heat or fuel import/production/export or process emissions. As a result, efficiency improvement measures could be regarded as a significant capacity reduction (10%) or as partial cessation of operations (Art. 23, 50% or more) by a sub-installation, leading to a corresponding reduced amount of allocation. If this problem is not properly addressed, the allocation rules will be counterproductive for efficiency improvements and for CO_2 reduction measures in fallback benchmark sub-installations.

We welcome that in the latest version of the Guidance Documents (n° 2, version v10.1 of 14 March 2011, page 35) physical changes aimed at improving energy efficiency or improvement with an end of pipe abatement technology to reduce process emissions should not be regarded as physical change leading to a significant capacity reduction.

Industry has proposed that Art. 3(j) – which is now in order – but also Art. 23 of the draft Commission Decision shall not apply to fallback benchmark sub-installations in case of abatement measures, provided that the operator will prove that the reduced consumption of heat or fuel or the reduced process emissions are indeed due to abatement measures.

This proof can be easily delivered: the reductions are due to abatement measures if the output of the industrial product remained within the thresholds defined in Art. 23. For district heating, the number of units to which heating or cooling is delivered is relevant. It should be made clear in the Guidance Documents that:

- Efficiency improvement and abatement ≠ capacity reduction;
- Efficiency improvement and abatement ≠ production reduction.

The fallback benchmarks – especially the heat benchmark allocation including district heating – are quite significant: about 25% of the total allocation to industry, according to the Commission.

Not accepting this proposal by industry, would be contrary to the aim of the ETS Directive (Art. 1) and especially Art. 10a(1): "*the measures shall ensure that allocation gives incentives for reductions in GHG emissions and energy efficient techniques"*. With our proposal above, we show that giving such incentives is easily feasible.

Note concerning significant capacity reductions

We further note that it is not yet mentioned in the Guidance Documents, that a lower allocation due to a significant capacity reduction is only justified if there is *"a significant decrease in a sub-installation's initial installed capacity **and** its activity level ...*" (draft Commission Decision, Art. 3(j)).

The activity level shall correspond to the *outputs* of a sub-installation. If the activity level – for the fallback sub-installations of the industrial products, see above – remains >/= HAL (Historical Activity Level) minus 10%, a lower allocation will not result.

11. Preserving competitiveness while maintaining environmental effectiveness: Allocation rules for heat shall not discriminate between heat from ETS installations and from installations classified as Electricity Generator

In general free allowances are allocated to the consumer of measurable heat, e.g. steam. Heat exported by ETS-installations to non-ETS installations is eligible for free allowances to the exporting ETS-sub-installation on behalf of the installation using the heat.

The problem is that heat exported by electricity generators, e.g. Combined Heat and Power (CHP) plants, underlies a different consideration in Guidance Document n° 2: free allowances credited to heat exporters classified as electricity generators are reduced by 1.74% (compared to 2013) each year from 2014. In this Guidance Document (n° 2, version v10.1 of 14 March 2011, page 25), this is expressed by the following formula for the calculation of the amount of allowances for heat to electricity generators:

$$F_{inst}^{final}(k) = F_{inst}(k) - 0.0174 \times F_{inst}(2013) \times (k - 2013)$$

This approach leads to a distortion for heat use and the resulting CO_2-emissions:

Heat and electricity are two separate products of a CHP-plant and electricity is assessed separately. Consumption of heat is the key to emission reductions rather than heat production. Since these power plants receive allowances on behalf of their non-ETS customers (heat consumers) a distinction between heat from electricity generators and heat from other ETS-installations should not be made.

Therefore, heat exported by a combined heat and power station (ETS-installation) or any other electricity generator and used by a non-ETS-installation is not to be treated differently from heat exported by an ETS-(sub-)installation because the heat is to be regarded as equal from the non-ETS heat consumer's point of view. The special treatment and the annual reduction mentioned above should therefore be refrained from.

In this particular case Art. 10(9) of the draft Commission Decision shall be overruled by the EU ETS Directive, which clearly states (Art. 10a(4) that the ***total*** allocation for heat to electricity generators shall be adjusted by the linear factor referred to in Art. 9 of the Directive. Avoiding competitive distortions and bringing these allowances also under a total cap will be achieved by simply applying the same cross-sectoral correction factor which is used for the other heat, if applicable in a certain year.

The EU ETS Directive aims at an EU-wide harmonised allocation and clearly states (recital 23): "*They* [the allocation rules] *should also avoid undue distortions of competition on the markets for electricity and heating and cooling supplied to industrial installations. They should further avoid undue distortions between industrial activities carried out in installations operated by a single operator and production in outsourced installations* [in this case to an electricity generator]".

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