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The EU ETS Union-wide rules for harmonised free allocation: IFIEC comments on the state of discussions

The legislative process to define the Union-wide rules for harmonised free allocation in the third trading period is entering its final phase. In this paper IFIEC outlines its position on key issues which are of vital importance to EU competitiveness. IFIEC calls on legislators to consider these positions when taking their decisions.

Besides the below points on the allocation rules, it is crucial that the benchmark values are set at the level of the 10% most efficient EU installations, as foreseen in the ETS Directive, and are not artificially decreased. Otherwise the aims of free allocation – to preserve competitiveness and to prevent carbon leakage – would be undermined. In the same spirit, the allocation rules for the fallback approaches should be realistic, taking into account i.e. the lack of access to the gas grid and unavoidable process emissions.

1. **The *Historical Activity Level* must be a representative production level to meet the Directive's target that sectors at risk of carbon leakage shall receive a 100% allowances free of charge based on ambitious benchmarks**.

   Therefore: HAL should be defined as the average of the period 2005 until 2009 with the option to delete two years.[1] This allows each sub-installation to exclude unrepresentative years and therefore results in a representative historical production level as a basis for allocation until 2020.

   The Directive stipulates that sectors at risk of carbon leakage shall receive 100% allowances free of charge based on benchmarks.[2] The allocation to these sectors will be based on a benchmark and a reference production level. For the latter, the Commission intends to use a Historical Activity Level (HAL). IFIEC does not see HAL as the best solution,[3] but this approach will be chosen, the following is essential: To fulfill the aims of the Directive – protect competitiveness as best as possible within the total cap and effectively tackle the risk of carbon leakage – HAL must be representative of the installations' normal production levels. In other words, unusual production years must not be considered (i.e. those characterised by the economic crisis or a maintenance shut-down). Otherwise, the allocation until 2020 would be based on an artificially low production level leading to an allocation which is lower than intended. This would negatively affect competitiveness and increase the risk of carbon leakage.

[1] Alternatively, average of the period 2005 until 2008 with the option to delete one year.
[2] Art. 10a (12)
[3] IFIEC has called for a system based on actual production levels, because the use of a historic - outdated - production level will increase the system's complexity and lead to distortions (i.e. need to adjust allocation to changes in capacity level; risk of over- or under-allocation depending on the economic development; need to eliminate incentive for carbon leakage).

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The median of 2005 until 2010 does not result in a representative production level for most installations. Considering that production levels were very low for at least two of the six years due to the economic crisis (2008 and 2009), the median will be defined by the lowest production level in the other years (2005-2007, 2010). This is especially problematic if 2010 is also marked by the economic crisis – as is the case for several sectors – or a sub-installation carried out a maintenance shut-down during that period, which – statistically – was the case for two thirds of all sub-installations. The median could therefore lead to a significant shortage of allowances and inhibit the further operation of installations.

2. **New entrants: Growth of efficient businesses must not be disadvantaged**.
   Therefore:
   a. **The condition of a "significant extension of capacity" shall be fulfilled if one of the following criteria is met: (i) an extension of an individual (physical) sub-installation's capacity of 10% or more; OR (ii) a capacity extension leads to an increase of the allocation of at least 10,000 allowances calculated on the basis of the applicable benchmark. Access to the NER shall also be granted if one of the thresholds is met after two or more consecutive expansions in the same manufacturing plant.**
   b. **The 'existing' installed capacity shall be defined as the Historical Activity Level.**
   c. **For the fallback approaches, the expansion of the industrial activity that is being supplied must be considered when defining access to the NER. This includes the expansion of activities not listed in Annex I but associated with such activities.**
   d. **The Linear Factor (LF) must not be applied to the individual allocation for new entrants. Instead, the cross-sectoral correction factor (CCF) should be applied, as for incumbents. Alternatively, as second best solution, the LF should be applied only when the CCF is applied.**[4]
   e. **The New Entrants' Reserve (NER) must be refilled.**
   f. **The Standard Capacity Utilisation Factor (SCUF) shall be calculated per product, based on the data of the 10% most efficient installations. Concretely, SCUF shall be the ratio of HAL and the highest yearly production level in the reference period. The SCUF for products without product benchmark shall be the arithmetic average of the product SCUFs of a sector.**

   a. The Commission intends to grant access to the New Entrants' Reserve (NER) only in case of a capacity increase of at least 20%. This rule would significantly disadvantage and discourage growing companies and productions – and would thereby be in breach of the Directive's aim to treat incumbents and new entrants equally. Effectively, the most competitive producers would have to pay for market share gains as most extensions will not meet the 20% threshold.[5] Furthermore, the threshold disregards a common industrial practice: capacity creep with debottlenecking (consecutive expansions and/or optimisations). As the building of new factories will often not be a responsible investment under the present market circumstances, most growth will come from debottlenecking. In sum, the proposed threshold would cause distortions and would be a clear signal on a no-growth policy.

      Instead, the growth of efficiently manufacturing businesses in the EU should be supported. With that aim in mind, the threshold for capacity extensions must be set at 10% at the level of the individual (physical) sub-installation (in line with recital 16 of the EU ETS Directive). In addition, a separate threshold must be included on the absolute increase of the allocation due to a capacity increase (10.000 EUAs per year). This shall allow significant capacity extensions of large sub-installations to qualify as new entrant – even if they do not meet the relative criteria on capacity increase due to their total size.

[4] Please see also point 7
[5] For large sub-installations a capacity increase of 20% amounts to an increase in allocation of at least 150,000 - 250,000 EUAs.

It should be clarified that the thresholds will be applied at the level of the individual physical sub-installation, as indicated in Art. 6[6]. To make this sufficiently clear, Art. 6.1(b) shall be amended as follows: "**one or more individual** heat consuming and heat producing sub-installations to which the heat benchmark applies". This is necessary to ensure a level playing field between the different permitting practices in the EU Member States (one or more sub-installations per permit) and between companies (having one or more same sub-installations on a permit site).

To take the industrial practice of debottlenecking into account, access to the NER shall also be granted if the threshold is met after two or more consecutive expansions in the same manufacturing plant, without any time limitation.

b. It is not possible to objectively define the 'existing' installed capacity on the basis of technical data. Therefore, IFIEC suggests to define the 'existing' installed capacity as the Historical Activity Level (HAL), which, importantly, brings consistency with the incumbents' allocation. This definition is adequate because the utilisation of the new capacity will be considered through the application of the Standard Capacity Utilisation Factor (SCUF). Moreover, HAL is readily available and therefore its use would not cause any additional administrative burden.

c. For heat-related allocation, the activity level of the industrial production consuming the heat is relevant.[7] The same is true for fuel-related allocation and process emissions. This intrinsic relation is referred to in the draft Commission Decision with the words: "heat consumed for the production of products or for the production of mechanical energy". Thus, in the context of the rules for new entrants, the activity level of the industrial production consuming the heat (or the fuel) must meet one of the above named thresholds to lead to additional allocation. In this context, production expansions of activities not explicitly mentioned in Annex I of the ETS Directive but directly associated with such activities (i.e. through the consumption of heat) must also be considered. These non-Annex I activities are in fact the basis of the three fallback methods. Otherwise, the system would lead to a perverse incentive in case of an extension of a so-called non-ETS activity: without any new heat demand, it would be profitable to build new boilers which would receive allowances from the NER. Equally, there would be no allowances for a new or an expanded industrial product plant if the new heat demand can be covered by using an existing boiler more efficiently.[8] Also, any expansion of a so-called non-ETS activity before or during the base period would be favoured vis-a-vis an expansion of the same non-ETS installation during the third trading period: While the first expansion will be considered for the allocation, the second will not.

We believe Section IV is not sufficiently clear regarding this point and therefore suggest to add the following paragraph to Art. 19: "This Article refers to all industrial production relevant for allocation, i.e. the activities listed in Annex I and any other directly associated activities which have a technical connection with these activities and could have an effect on emissions. This Article shall not apply to the inputs falling under the heat benchmark or the fuel benchmark and the outputs by the process emissions benchmark."

d. Contrary to some interpretations and in line with the treatment of incumbents, the Linear Factor of 1.74%/year shall not be applied to the individual allocation of new entrants but to the total cap as meant in the Directive (Art. 9).

[6] Art. 6: "(...) each installation (...) shall be divided into the following sub-installations, corresponding, to the extent possible, to physical parts of the installation."

[7] The same principle applies in the context of significant reduction of capacity or (partial) cessation of operations. Please see point 6 of this paper for this issue.

[8] As the efficiency of heat use increases, also due to the ETS, spare boiler capacity will increasingly become available. It would be economically and ecologically sensible to use that spare capacity for the supply of new entrants. However, if not the above approach will be followed, there would be the perverse effect of incentivizing to build a new, unnecessary boiler.

e. According to the Draft Commission Decision, the allocations from the NER "shall be made on a first come, first served basis" (Art. 21(5)). If the NER would be fully exploited, this rule would penalise those new entrants that start production later in the third trading period. This would stall growth and would disadvantage new entrants in those countries with lengthy permitting procedures. To ensure equal treatment with incumbents and earlier expansions, the NER should be refilled, as is current practice in most Member States in the first and second trading period.

f. The calculation of SCUF should be done per product, based on the data of the 10% most efficient installations because new entrants – whose allocation will depend on SCUF – will have a comparable utilisation rate to the best existing sub-installations. Concretely, SCUF should be calculated in two steps:
   - For each sub-installation with product benchmarks falling under the 10% most efficient, the installation-specific SCUF shall be calculated as HAL divided by the highest production year in the reference period.
   - The product-specific SCUF shall be the average of the sub-installation-specific SCUFs.

   For products without a product benchmark, SCUF shall be the arithmetic average of the installation specific SCUFs of a sector. This pragmatic procedure avoids to define a technical capacity for each sub-installation in the Community – which we consider impossible in an objective way – and makes the allocation for new entrants consistent with the allocation for incumbents. The administrative burden will be negligible.

3. Allocation must be consistent with the calculation of the maximum amount of allowances for free allocation.

To ensure this, a new point shall be added under Art. 10 "The allowances to be allocated for free for the heat production of electricity generators (irrespective whether allocation is to the consumer or the producer) and for their electricity production from waste gases should be taken from the amount for auctioning."

Since the definition of an "installation" provided in the EU ETS Directive is not implemented in EU Member States, it depends on the permitting practice whether certain emissions are considered to be associated to an "electricity generator" and thus calculated towards the amount for auctioning, or – if not – to the maximum amount for free allocation. While in some Member States an installation may be equivalent to a whole industrial site (wide definition), in other cases and other Member States each plant on an industrial site is considered a separate installation (narrow definition). As the narrow definition prevails for most combined heat and power plants and for electricity produced from unavoidable waste gases, these "installations" are regarded as electricity generators (even though the activities are directly associated with an industrial activity) and their emissions are calculated towards the auctioning cap. However, these installations will receive free allocation according to Art. 10a(1) and 10a(4). As the emissions of these installations are not counted towards the maximum amount of allowances for free allocation, this would lead to a distortion and possibly an unjustified early application of the uniform cross-sectoral correction factor (CCF). Since the CCF does not take into account CO_2 abatement potential, it weakens the effectiveness of benchmarking in preventing carbon leakage.

This issue is of great significance. This becomes apparent when considering the impact of the "wrong" attribution of the emissions from combined heat and power plants and from electricity production from waste gases. According to our calculations – based on conservative estimates – this would decrease the maximum amount of allowances for free allocation by 10%.

There are two possibilities to avoid this inconsistency:

a. The maximum amount of allowances for free allocation is calculated correctly if the definition of an "installation" is implemented throughout the EU.[9] Accordingly, the above named emissions would be part of the industry cap.
b. The allocation must be carried out in such a way that it is consistent with the calculation of the maximum amount of allowances for free allocation. In other words, the allowances should be taken from the amount for auctioning if the emissions of an installation where counted towards that amount and vice versa.

As option a. does not seem feasible in the present time schedule, IFIEC calls for the implementation of option b.

4. The heat benchmark must be set at the realistic value of 0.0623 allowances/GJ.

The draft Commission Decision proposes a heat benchmark value of 0.0603 allowances /GJ which can be interpreted as having chosen natural gas as reference fuel with a conversion efficiency of 93%. A conversion efficiency of 93% is technically not feasible for highly efficient combined heat and power plants in the industry because of (i) efficiency losses due to combined production with electricity, (ii) efficiency losses linked to the production of high temperature steam needed in the industry, and (iii) heat losses in the distribution network. To avoid disadvantages for highly efficient CHP plants, the heat benchmark value should be set at 0.0623 allowances /GJ which corresponds to the assumption of using natural gas as reference fuel with a conversion efficiency of 90% (commonly used as a target value in various legislative documents).

5. The free allocation for process emissions should not be subject to a reduction factor

The draft Commission Decision foresees a reduction factor of 0.9391 for the free allocation granted to process emissions on the basis of their historical activity levels (third fall-back approach). Such a reduction factor should not be applied because:

- Unlike fuel or energy-related emissions, process emissions are predominantly the result of a chemical process which cannot be reduced beyond its physical limit.
- A general application of the proposed reduction factor to all installations would burden early movers to the same extent as bad performers.
- The additional costs induced by the reduction factor would make recycling processes unprofitable.
- The reduction factor would reduce the incentive for CCS in the future.

6. Significant capacity reduction and (partial) cessation of operations: To maintain the incentive structure of the ETS – to increase efficiency and decrease emissions – , the allocation of an installation shall only be adjusted in case the capacity or the activity level of the relevant industrial production decreases substantially.

The rules on significant capacity reduction (Art. 23), cessation of operations (Art. 24) and partial cessation of operations (Art. 25) foresee a reduction of the allocation in case of a significant decrease in capacity or activity level. These rules must not apply to inputs (heat and/or fuel) or outputs (process emissions). Otherwise, the incentive to reduce emissions through i.e. a more efficient heat use would be nullified because this would result in lower allocation. This would be contrary to the concept of benchmarking. Therefore, Art. 23, 24 and 25 shall only apply to the production of industrial products. The exception must be district heating because in this case a reduction in the heat production may also be the result of less heat consumers.

[9] Art. 3e: *""installation" means a stationary technical unit where one or more activities listed in Annex I are carried out and 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;"*

To that aim, the following paragraph shall be added to Art. 23, 24 and 25: “This provision applies to industrial production. It does not apply to the three fallback methods (heat benchmark, fuel benchmark and process emissions) with the exception of district heating, unless the district heating operator can demonstrate that the reduced heat production results from more efficient heat use.”

7. **Application of the linear factor and the cross-sectoral correction factor must ensure equal reduction efforts by all ETS installations**

The Union-wide quantity of allowances decreases in a linear manner until 2020. To ensure that all ETS installations equally contribute to the reduction effort, the linear factor (LF) must be applied to the total amount of allowances but not to the individual allocation. Instead, the cross-sectoral correction factor (CCF) should be applied – when necessary – to the allocation to incumbents (Art. 10a(5)), to new entrants (Art. 10a(7)), to installations producing electricity from unavoidable waste gases (Art. 10a(1)), and installations producing heat (Art. 10a(4)).

Alternatively, as second best solution, the LF should only be applied to the allocation to installations not covered by Art. 10a(5), when the CCF is applied to installations covered by Art. 10a(5).

8. **Clarify definition of sub-installations to ensure a level playing field in the EU**

It is important that one heat benchmark sub-installations on an industrial site is one individual (physical) sub-installation (rather than the sum of several installations on one site that are allocated according to the heat fallback). This is necessary to ensure a level playing field between the different permitting practices in the EU Member States (one or more sub-installations per permit) and between companies (having one or more same sub-installations on a permit site).

That the legislator has this intention becomes apparent in Art. 6 of the Draft Commission Decision: “(...) each installation (...) shall be divided into the following sub-installations, corresponding, to the extent possible, to physical parts of the installation.” However, to make it absolutely clear that the individual physical sub-installation is meant, Art. 6.1(b) shall be amended as follows: “**one or more individual** heat consuming and heat producing sub-installations to which the heat benchmark applies”.

9. **A comprehensive carbon leakage policy within the framework of the EU ETS needs to address direct and indirect emissions equally. Therefore, the revised state aid rules setting the conditions for the financial compensation of the ETS impact on power prices should be adopted together with the rules on benchmarks.**

The policies on direct and indirect emissions need to ensure equal treatment between companies using fuels directly and those that use electricity. This is particularly obvious for production processes with interchangeability of steam or fuel with electricity: while the companies that use fuel or steam will receive free allocation of allowances, the electro-intensive companies shall receive financial compensation. To ensure this and thereby avoid distortions within one product market between companies using fuel or steam and those using electricity,

- it is important for industry to know the conditions for the compensation of indirect effects when evaluating the benchmarks.
- the products identified as being characterised by exchangeability of fuel and electricity (see Annex I (2) of the draft Commission Decision) should automatically qualify for financial compensation of the ETS impact on power price. Building upon this list, it is essential that other processes characterised by the exchangeability of fuel or steam and electricity are also considered as well as those processes exposed to a significant risk of carbon leakage due to the total costs of ETS (direct and indirect). For further details, please see IFIEC position paper (“ A successful EU Emissions Trading Scheme post 2012: Adequate compensation of power price impact is needed”, 19 April 2010).

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About IFIEC Europe
The International Federation of Industrial Energy Consumers represents companies in energy intensive industries in Europe for which the cost and availability of energy and power are significant factors affecting their ability to compete in world markets.