INTERNATIONAL FEDERATION
OF INDUSTRIAL ENERGY CONSUMERS

IFIEC Europe

Brussels: 30 October 2006

EU-Emissions Trading Scheme without real changes:
A threat for EU Industry
An obstruction for competition in the liberalized electricity market

IFIEC, the European Federation of industrial energy consumers, represents energy intensive industrial energy consumers in Europe. The members' industrial activity is heavily dependent on secure and competitive power supplies for their production purposes. A truly liberalised electricity market, where competition leading to fair prices for both the supply and the demand side, is a priority objective. Unfortunately, this is far from being the case, yet it is a prerequisite for the competitive future of EU industry.

The interim results from both the EU Commission's Sector Inquiry and the High Level Group provide clear pointers to the problems and that alternatives are currently being intensively looked at and discussed at both EU and national levels.

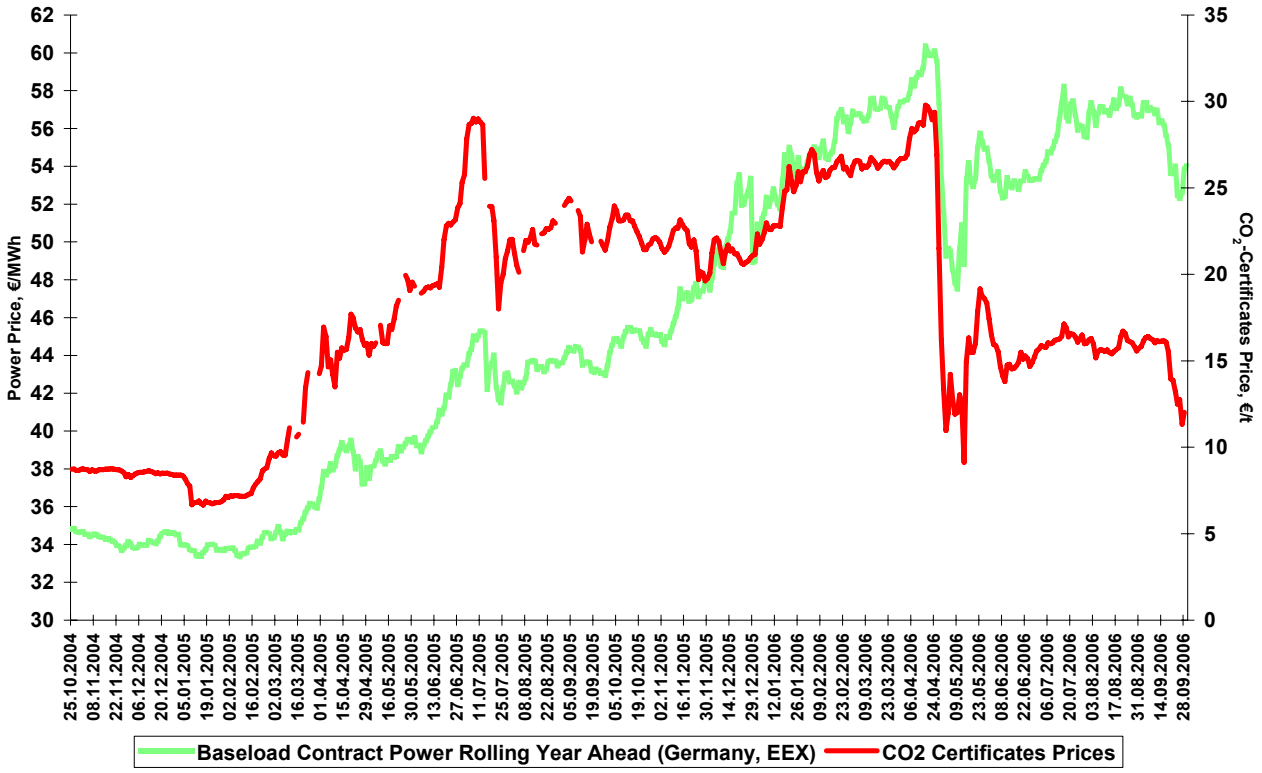
Whilst this debate continues, it must not be forgotten that the current EU Emissions Trading Scheme (EU ETS) presents a serious danger both to the development of effective competition in the EU electricity market and to competitive and fair prices being charged to all consumers. EU ETS needs a full review so that the existing flaws are identified and addressed and a different approach implemented. This is essential in order to bring EU ETS in line with the EU's objective of building a truly liberalised electricity market, so linking the EU's Kyoto obligations with its Lisbon strategy aims.

A different approach exists and has been promoted by IFIEC and others. This involves an output related allocation based on benchmarks to improve EU ETS in terms of CO_2 reduction effects and its effects both on the electricity market and on the competitiveness of the EU as a whole. Neither the existing EU Directive nor the fixed Kyoto targets are obstacles to introducing this more reasonable and effective approach.

A threat for EU industry

The effects on the power prices of EU ETS are enormous. As an example, since the start of CO_2 certificates trading in Germany, the power price has increased by €20/MWh or nearly 60 percent, much of which is due to the price driver effect of CO_2 certificates. This has meant windfall profits for electricity producers costing consumers about €5bn per year in Germany alone. The industrial consumers with intensive power needs for their production are particularly affected and face huge, new and unjustified costs on their electricity bills.

Head Office: 200 Avenue Louise Box 132 B- 1050 Brussels
Tel: 32 2 542 06 87 Fax: 32 2 542 06 92
www.ifieceurope.org – E-mail : ifieceurope@ifieceurope.org



Picture: German Power and CO_2 prices

By comparison, the EU Commission estimates that the overall potential cost savings resulting from more cost-efficient options for CO_2 reduction due to an emissions trading system is in the order of €4 to €5 billion per year across the EU. Such a disproportionate situation is not acceptable and needs urgent correction!

An obstruction for competition in the liberalized electricity market

EU ETS in its current form serves as a very effective tool to prevent change in traditional market arrangements:

- It has removed any motivation for an existing producer to win market share by using the existing capacities more intensely.

  Explanation: Certificates to match existing production are issued free of charge, so the market price for the emitted carbon can be "passed through" in electricity costs, but additional certificates must be purchased, allowing only cost recovery opportunity. The additional production thus distorts the producer's overall profit margin in every case!

Examples

Original Situation: Production in a marginal coal plant, offered at a price which includes the whole certificates value at an assumed price of €25/MWh (assumption: emissions of 1t/MWh).

New situation - Going for market share:

1. via price: With a gross margin of assumed €20/MWh. Here the cost of allowances is €25/MWh, so the result is negative. At this margin it is better to sell allowances rather than to produce electricity.

2. via marketing: The minimum gross margin at this CO_2 price is €25/MWh, but the cost of allowances is also €25/MWh. The net result is zero, so more marketing does not improve profit levels.

Withholding available capacity can have the effect of maintaining high electricity prices, so should be considered one of the most efficient potential means of abusing market power. EU ETS in its current form adds a new incentive not to use the available capacity to the benefit of the consumers!

- It includes significant disadvantages for new entrants in comparison with the incumbent players.

The allocation method is based on grandfathering and disadvantages new entrants in respect of transfer rules. When replacing an old plant, existing incumbents can transfer their grandfathered allowances to a new plant, while new entrants have to buy the allowances needed. This means new entrants facing a significant investment disadvantage. The EU Commission in its Guidelines from 2006 supports this, stating: "having new entrants buy all allowances would be in accordance with equal treatment." EU ETS thus has the effect of a protective measure for incumbent players.

An Alternative to cap and trade in line with EU Directive and Kyoto obligations exists: Output related Allocation

These above problems are not inherent to an emissions trading scheme as such, but are based on the EU rules. An alternative approach is to adopt an output related CO_2 emissions regime. This means granting allowances ex post adjusted, i.e. using actual production based on a relevant performance standard.

- The opportunity cost principle would not apply and opportunity costs would not be part of the market price of electricity.
- The effect of freezing the original market share is to the detriment of new entrants and competition in general and would be removed.

Furthermore, such EU ETS approach would not be in breach of either the existing EU Directive or the Kyoto obligations. The EU Directive requires that the total cap is guaranteed, but does not exclude ex post adjustments on individual producers. Also an output related system could ensure the overall cap is met. For example, a reserve fund could accommodate higher growth than forecasted with performance standards to be adjusted if necessary in order to safeguard meeting the cap at the end of the period. In this way, the essence of an output related allocation with a guarantee of the total cap would be that ex-post adjustments of certificates allocation are carried out for the individual producers while at the same time the reserve fund and possible performance standard adjustments for future years would ensure the total cap.

Conclusions

Conclusions must be made now about the detrimental effects of the current EU ETS, many of which have been identified and highlighted by the High Level Group. IFIEC Europe believes a new, output related approach should be given serious consideration as at least one way of improving the current, seriously flawed scheme. This would be an effective means to improve the situation on the electricity market, to vitalize the liberalization process and to bring competitive elements into this market.

It is inconceivable that these serious issues are considered only as part of changes to be made in the post Kyoto arrangements for after 2012.

IFIEC Europe appeals to the political decision makers of the EU to take immediate measures to improve the Emissions Trading system in order to support the liberalisation process in the electricity market and to help realizing the EU Lisbon strategy for a more competitive Europe.