

ETS – evaluation of 3rd trading period and proposals for post-2020 Discussion note

This discussion note is a contribution to the upcoming debate on the future of the ETS. Points 3) and 4) of this note suggest structural changes to the current ETS which are meant to tackle its major defaults. It is Fedil's intention to discuss the suggested changes with stakeholders and thereby to test if they can be considered as valid or if there is a need for adaptations. The attached graphs are illustrations. The post 2020 trends and figures are indicative.

1) The need for an early decision on post-2020 ETS

- ✚ The current ETS system combined with the perspective of a constantly decreasing ETS cap is very likely to become a major threat to industrial development in the EU.
- ✚ The attempt by the European Commission to backload or to withdraw emission rights from the current ETS is an inadequate measure that has to be avoided. Structural changes have to be developed instead.
- ✚ Investors need a long term perspective including production volumes that can be produced under economic conditions.
- ✚ Energy intensive manufacturing industries need clarity regarding the potential future energy cost differential between European production sites as compared to alternative non-European sites.
- ✚ Industry wants to avoid inadequate (technological) lock-ins.
- ✚ An early decision on a post 2020 roadmap for the ETS would underline the importance of this economic instrument as a priority tool for climate policy and beyond (e.g. renewable energy policy)

2) 3rd trading period

2.1. Main characteristics

- ✚ ETS cap
- ✚ Cap = decreasing 1,74%/year with 2008-2012 average yearly emissions as starting point in 2010.
- ✚ Difference between Carbon-leakage and other sectors
- ✚ Full auctioning for the power sector
- ✚ Free allocation for C-leakage according to the following formula:
Production (historic 2005-2008) * benchmark * cross sector correction factor
- ✚ Cross sector correction factor to keep the historic relation (2005-2008) between C-leakage sectors and other sectors.
- ✚ Reserve = 5% of cap

2.2. Positive implications

- ✚ Guarantee to meet a certain cap
- ✚ Level of allocation rights for a given installation is fixed for the whole trading period.
- ✚ Free allocation against carbon leakage
- ✚ Harmonized allocation rules as compared to distortions that arose from NAPs

2.3. Negative implications

- ✚ The current ETS system encourages decreasing production and creates a fundamental uncertainty about the possibility to realize future production volumes (impacting negatively investment decisions).

- ✚ Allocation as compared to historic production does not take into account economic slowdown or high growth rates.
- ✚ C-price is very much affected by economic performance of the covered sectors
- ✚ No long term perspective for investors
- ✚ Indirect costs, especially for energy intensive industries
- ✚ Production costs in the EU are higher than outside the EU
- ✚ Distorts inter-material competition favoring materials with low emissions for marginal production volumes disregarding bonuses or penalties for recycling and end-of-life CO2 emissions.
- ✚ The existence of windfall profits in different sectors shows that the system is not efficient and that there is no guarantee the ETS leads to the lowest overall abatement cost.

3) Options for post 2020

3.1. Assumptions

- ✚ The EU maintains its climate policy based on decreasing emission levels
- ✚ No level playing field compared to third countries ('similar' systems not being a sufficient guarantee to create such a level playing field)
- ✚ ETS becomes the cornerstone of EU legislation in the fields of climate policy, renewables and energy efficiency within the covered sectors.
- ✚ The power sector and manufacturing industry need a long term perspective in order to improve the investment climate.

3.2. Risks of going on with the 3rd period system

- ✚ Further isolation of the EU fixing caps whereas other regions prefer performance targets or different ambition levels.
- ✚ Carbon leakage as a consequence of deteriorated industrial competitiveness.
- ✚ Difficulty to keep the principle of real free allocation with a decreasing overall cap.
- ✚ A clear indication of decreasing caps for the coming decades might be considered as a clear long term perspective by the power sector. The other manufacturing industries however will consider this as a potential threat. As a consequence, disinvestment is likely to become their long term perspective.
- ✚ Economic growth will be hampered by an overall cap.
- ✚ Economic slowdown and closures of installations will remain major drivers of climate policy.
- ✚ No guarantee that ETS will promote green innovation – rather restructuration and closure of the lowest EBIT/tCO₂ yielding sectors/entities transferring CO₂ quota under the cap to the remaining ones.
- ✚ Indirect impact of higher prices for industry as a result of ETS. The recent state aid guidelines are only a very partial solution to this problem.

3.3. Options for post-2020 ETS

- ✚ Give the Power sector a long term perspective (2030, or even 2050) in terms of a decreasing cap.
- ✚ Take advantage of the ETS to make it the key instrument to address renewable energy goals.
- ✚ Put in place structural measures that allow to mitigate significantly the competitiveness problems caused by indirect ETS effects on industrial power prices
- ✚ Take manufacturing industry out of the cap and give it a long term perspective in terms of free allocation independently of their future production level. Let industrial emissions float according to the benchmarks and the level of real production (performance based instrument).
- ✚ New allocation rules:
 - ⤴ Multi-decade perspective of a decreasing cap for the power sector according to feasibility studies including possible power price impacts. Auctioning of emission rights to the power sector
 - ⤴ Annual ex-post allocation to manufacturing industry according to the following formula:
[Sector benchmark] * [past year production level of the individual installation]
 - ⤴ Benchmarks not as ambitious as average of best 10%. Benchmarks to be reviewed every ten years
 - ⤴ No correction factor to be applied as manufacturing industries do no longer have to fit an overall cap
 - ⤴ Banking within trading periods and between trading periods
 - ⤴ A certain level of access to flexible mechanisms
- ✚ Increase incentives for creativity and enhancing attractiveness for industry sectors with little abatement potential to generate novel ways of C-abatement techniques.
- ✚ Implement appropriate support and conditions to develop R&D results to maturity with a specific focus on risk hedging.
- ✚ Organize a sound measurement of the effectiveness of the climate change policies by precise monitoring of the C-intensity of the EU consumption.

4) Options for post 2020 compared to 3rd trading period

- ✚ 100% performance based system for manufacturing industries with no incentive to lower industrial production in Europe. No implicit reward for net industrial closures.
- ✚ No barrier to dynamic expanding industries.
- ✚ No need for a new entrant reserve as allocation to new entrants would be automatic according to the allocation formula.
- ✚ Effects of economic fluctuations on manufacturing industries would be neutralized.
- ✚ No need to call for ex-post cap-adjustments or price-supporting interventions as planned by the EC for the start of the 3rd trading period.
- ✚ Increased pressure to improve technical performances, the only possible way to bring down unit carbon costs or to create carbon value.
- ✚ In the absence of an international agreement, the system would offer a level playing field for European industries that perform according to their sectorial benchmark.
- ✚ No more absolute cap for the ETS, as manufacturing industries' emissions would depend on the benchmark and the real production levels; but possibility to have a good perspective of total ETS emissions, as industrial production capacities and the possible degree of capacity utilization would not deviate significantly from previews.
- ✚ Sustainable measures to tackle indirect power price effects for power intensive industries instead of partial compensation by State aid measures
- ✚ An improved coordination between climate policy and supporting policies, such as R&D policy or complementary policies, such as industrial policy.

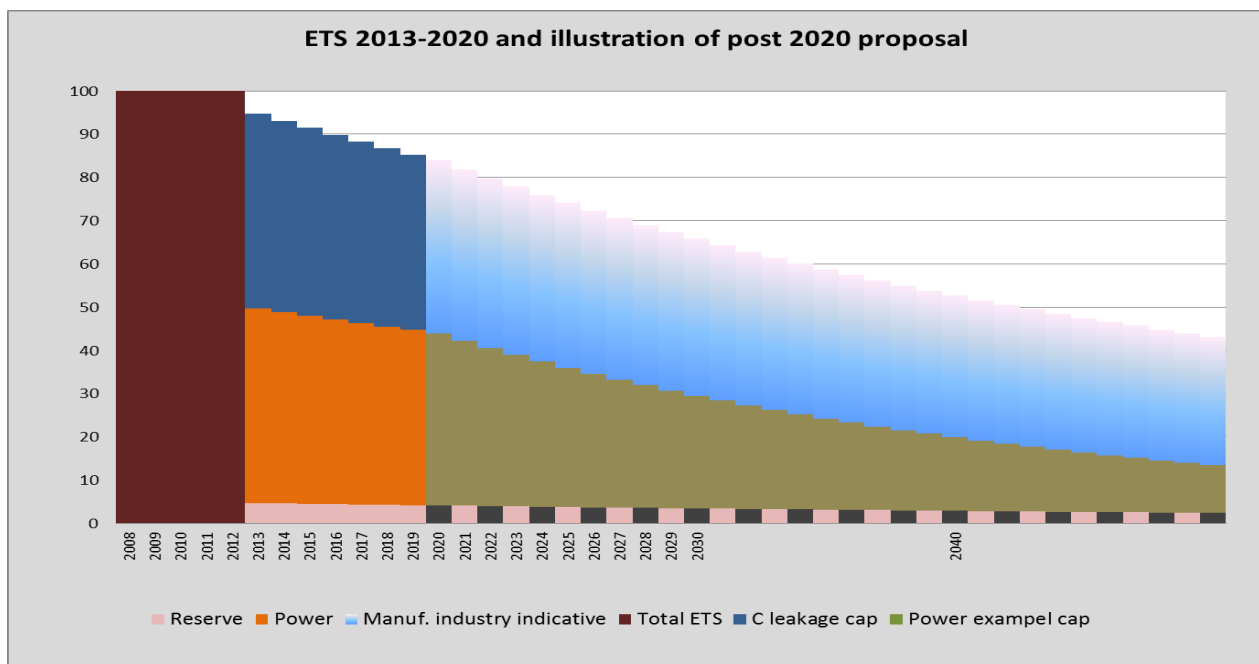
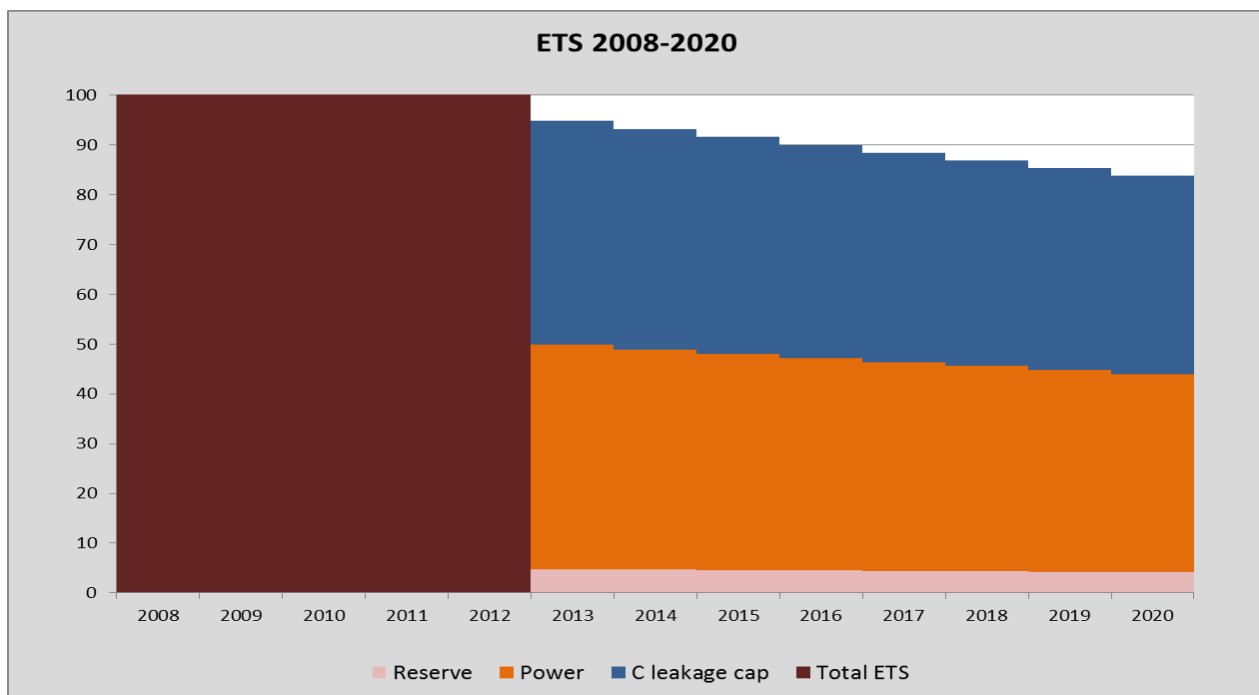


Illustration:
Net supply & demand of manufacturing industry sectors according to benchmarks

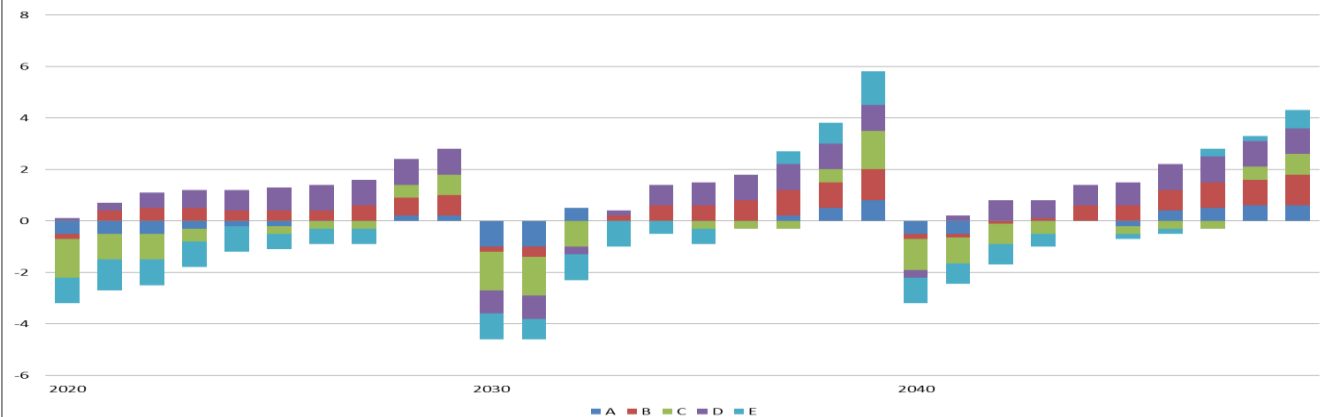


Illustration:
Sum of net supply & demand from manufacturing industry

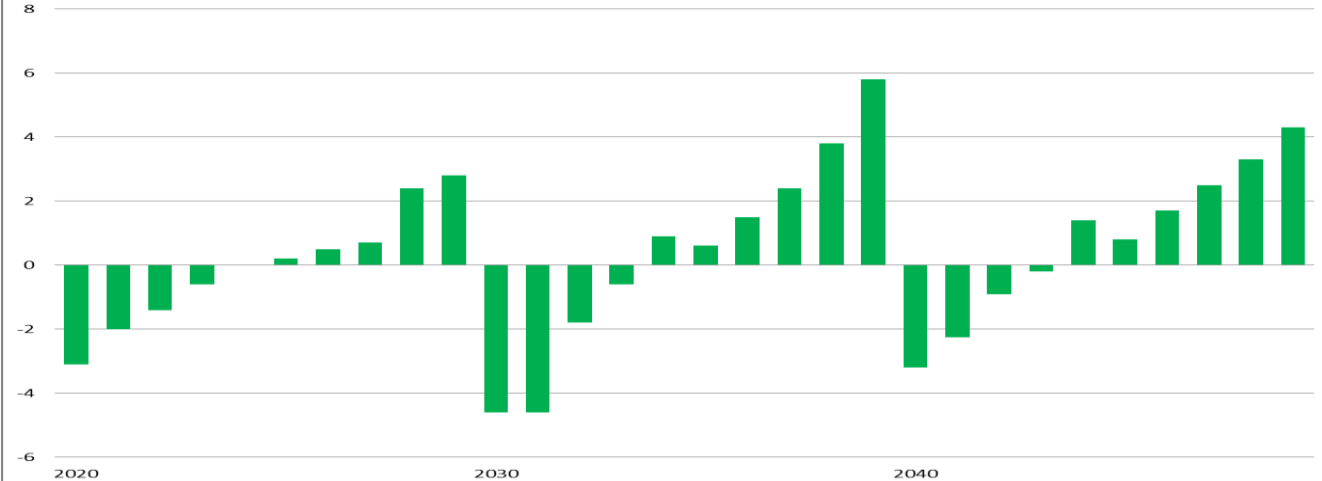


Illustration:
power sector cap with manufacturing industry net impact

