



Submission on a proposal to revise the EU ETS

2 December 2015

Ibec is the largest business representative organisation in Ireland: we speak for over 7000 member companies across a range of industrial, commercial and non-profit sectors. The organisation and its sector associations strive for business conditions that enable economic growth. This response was prepared by the Ibec Climate Change working group which includes a cross-section of companies spanning a number of sectors including energy generation, energy supply, food and drink, pharmaceuticals and building materials. It reports to the Energy Policy Committee.

We thank the Department of Environment Community and Local Government for the opportunity to comment on the European Commission's proposal for EU Emissions Trading Scheme (ETS) reform. This submission should be read in conjunction with our response to the European Commission's request for comments on the same document (appendix a).

The ETS reform is based on the foundation of meeting the EU's agreed carbon emission reduction cost-effectively. In the absence of a global agreement on carbon emissions reduction, the challenge for EU decision-makers is to use the ETS to encourage further emission reductions industry without negatively impacting on European industrial competitiveness. As we outlined in our proposal to the European Commission, if the ETS is to remain the main tool for least cost emissions reduction while promoting investments in low carbon technologies, it must address the loss of competitiveness and carbon/investment leakage through effective, evidence-based measures.

The points outlined below are considered against the backdrop of the European Council's strategic guidance of October 2014. The conclusions confirm that the share of auctioned allowances must stay the same after 2020 accompanied by appropriate levels of support for sectors at risk of losing their international competitiveness.

The submission specifically addresses the following issues:

- Linear reduction factor;
- Auction share;
- Free allocation and carbon leakage provisions
 - o Benchmarks
 - o Process emissions
 - o Alignment with recent production data
 - o Carbon leakage;
- Indirect carbon costs;
- Installations with low emissions (small emitters) – (please see appendix b);
- Transition to the system of delegated and implementing acts.

1) Linear reduction factor

The overall quantity of allowances will decline by 2.2% every year starting from 2021. We understand that the linear reduction factor is required to meet the 43% reduction by 2030 in the Emissions Trading Scheme, however carbon leakage protection measures should not exclude exposed sectors and our insights seek to address some areas that could have a negative impact on Irish-based industry.

2) Auction share

Over the current trading period, 57% of the total amount of allowances will be auctioned and the remaining allowances are available for free allocation. The remaining allowances are available for free allocation. While we understand that the Council conclusions, it must be recognised that the declining cap and the fixed split between auctioned and free allowances could impact even the best performers.

3) Free allocation and carbon leakage provisions

a) Benchmarks

In broad terms, the benchmark values for free allocation will be adjusted to avoid windfall profits and reflect technological progress in the period between 2007-2008 reducing by 1% each year thereafter (a different methodology will be applied if the benchmark values differ from the annual reduction by more than 0.5%, whether higher or lower).

Undertakings at significant risk of carbon leakage should not bear additional direct or indirect carbon costs up to the benchmarked level of carbon efficiency (average best 10%). However the proposal would automatically tighten the benchmarks by 1% annually (commencing in 2008). The Commission appears to have recognised that this automatic tightening cannot “reflect technological progress” as it is not based on any data concerning real progress. If the data shows that the real value of technological progress differ from the assumed 1% per year reduction by more than 0.5%, then the assumed rate of improvement can be adjusted to either 0.5% or 1.5% as appropriate. However, none of these rates (neither the 1% automatic tightening nor the 0.5% or 1.5% adjusted tightening) would actually reflect the real level of technological progress, which tends to occur in step increments, and could potentially discriminate between and against sectors depending on the technological progress that has been, and can, actually be made. As discussed below, the arbitrary approach also fails to account for sectors that cannot innovate or make their processes more efficient.

b) Process emissions

Process emissions and combustion emissions should be separated. Considerable progress has been made by European industry in reducing carbon emissions associated with fuel combustion. But so called ‘process’ (non-combustion) emissions arising directly from the raw materials cannot be reduced any further without significant progress in the development of certain technologies. This needs to be addressed in the reformed ETS to ensure that innovation is supported to deliver the breakthrough technologies required to allow for reliable and cost effective carbon capture.

For some sectors, like cement and lime, there are significant and specific difficulties. The chemical properties of the base raw material limestone (i.e. Calcium Carbonate) fixes a fundamental lower emission limit. In simple terms, approximately 60-70% of the CO₂ emissions arising from these industries can be attributed to the chemical properties of limestone. Breakthrough technologies for carbon capture will be required to allow these industries to achieve emission levels below this fixed limit. No technological advancement can change the chemical properties of certain raw materials.

The combination of the current Commission proposals for benchmark adjustment together with the cross-sectoral reduction factor could result in allocations to some industries dipping below this fixed, raw material emission limit by as early as 2027. In such a scenario there would be a requirement for cost-effective and reliable carbon capture technology to be installed and operational in the next 10 years. This is highly unrealistic based on the current pace of development of this technology. The European Commission has said that technological improvements so as to reduce to process emissions are essential and the innovation fund is in place to enable these developments but it is important to consider that technological improvements may not progress at the required pace.

It is essential therefore that free allowances for ‘process’ emissions are made available to all ‘at risk’ sectors, as technological constraints in a number of sectors will limit the scope for reduction.

c) Alignment with recent production data

Production levels for 2013-2017 and 2018-2022 will be used to inform and update allocation for 2021-2025 and 2026-2030 respectively.

The Commission proposal retains a system of allocation based on historical activity levels that are recalculated every five years. However, this would still mean that within each five year period, companies that grow would have to purchase allowances and companies that decrease production would receive more than they need.

The Commission appears to acknowledge this problem. Their proposal includes the creation of a reserve of allowances that can be used to adjust allocations in light of “significant” production changes within the five year period. Its effect would be to give additional allowances to, or take allowances away from, an undertaking if they grow or cease production by more than the threshold needed to qualify as a “significant” change. Under the current regulations this threshold is 50%.

Ibec supports a simpler system that avoids this penalty for growth altogether. Under this system companies would receive enough allowances to cover their production (at benchmark levels of efficiency), no more and no less. The level of free allocation to a company in a given year would be based on recent (prior year) production data. If production expands it would have access to additional allowances from a reserve (i.e. the Market Stability Reserve) and if it reduced production it would be required to surrender excess allowances to the reserve.

a) Carbon leakage

There are new rules to define sectors at risk of carbon leakage. There is 100% of benchmark level for exposed based on quantitative and qualitative criteria and 30% of benchmark level for non-exposed. In a change to the current methodology, sectors will be categorised at NACE-4 level.

The proposal seeks to direct carbon leakage protection towards sectors that are at genuine risk of exposure. The current ETS Directive set out criteria for assessing exposure to carbon leakage based on trade intensity, carbon intensity and/or the technological and economic possibilities for the sector to reduce its emissions.

The current proposals amend these criteria but they would still impose arbitrary cut-off points and they would be no more likely to identify those sectors that are “genuinely” at risk. There is currently no accurate methodology for determining whether, when and to what extent sectors are able to pass carbon costs on to consumers. It is undisputed however, that passing through EU carbon costs will reduce the competitiveness of EU companies versus their international competitors, thereby potentially chasing investments outside the EU.

The decision to only award carbon leakage protection under the quantitative methodology at the NACE-4 code level will fail to recognise certain exposed sub-sectors and sub-sectors will be excluded from carbon leakage protection. The practical effect of the proposals would be to tighten the criteria, and thereby to deny full carbon leakage protection to roughly 120 small sectors, including a number of sub-sectors within the dairy industry. These sectors would still be at risk of carbon leakage but they would only get 30% of their free (benchmark) entitlement.

The Commission has failed to provide sufficient evidence that the revised criteria would more accurately identify sectors at genuine risk. A better methodology is required to assess carbon leakage exposure.

b) Tiered carbon leakage

The Czech Republic, France, Slovakia and the United Kingdom recently published a non-paper for a revised method of allocating free EU Allowances between installations. We understand that this

would involve a more nuanced ranking of the various industry sectors on the revised carbon leakage list according to their perceived degree of risk exposure.

Currently, a variety of views exists amongst our membership on the merits (or otherwise) of this idea. This is partly explained by differing interpretations (and some confusion) over how it might impact on a given industry sector in Ireland. The proposal that we have seen is somewhat vague on how Tiers would be constructed. It may ultimately be possible to reconcile the disparate views, but to do so would require greater clarity on the formula by which (i) trade intensity, (ii) carbon intensity and (iii) indirect costs would impact on the 'Tiering' classification of each ETS installation.

4) Indirect carbon costs

There is no harmonised approach for compensating indirect costs which remains at the discretion of member states. The proposal reinforces that rationale for Member States to compensate, by replacing “may” with “should”.

The EU ETS was designed to function as a neutral instrument that sets a cap for all installations covered by it. Therefore as outlined above the European Commission has established and is proposing revised rules for. Compensation is given as free allocation to exposed industries, to compensate the direct costs of the ETS, according to common rules for all countries.

Member States are allowed to compensate for the indirect costs incurred from increased electricity prices but there is no harmonised and it remains at the discretion of Member States. However, the proposal reinforces the rationale for member states to compensate by replacing “may” with “should” and Member States are encouraged to use Allowance auction revenues to provide compensation in line with state aid rules.

A number of Member States have notified compensation schemes for indirect costs to the European Commission.¹ Ireland does not provide such compensation for qualifying companies. The price of EU Allowances has mainly come under €10/t over the last decade. However following the adoption of the Market Stability Reserve, several analysts forecast a price of around €20/t by 2020. If current plans to reform the ETS were to be enhanced, EU Allowance prices could eventually be driven well above €50/t. The direct and indirect costs impact of the ETS is therefore expected to significantly increase in phase 4.

While in some cases energy-intensive sectors are able to pass on the costs, in many instances this is not possible as it would automatically make some commodities/products uncompetitive in the global market.

The European Commission is expected to publish guidelines on indirect costs towards the end of 2016. While it is beyond the scope of these guidelines to set mandatory compensation measures to offset indirect costs, the Irish government must consider providing compensation for indirect costs in the case of an increasing EU Allowance price.

From our perspective, the only satisfactory remedy to address the issue of indirect costs is a harmonised EU approach funded by auctioning revenues. This could be fully funded from the expected increase to ETS auction revenues from an increasing carbon price.

5) Transition to the system of delegated and implementing acts

¹ Spain, Germany, Netherlands, UK, Belgium and Greece provide compensation for indirect costs.

a) Delegated acts

Under the Treaty on the Functioning of the European Union (TFEU), the Union legislators may entrust the European Commission with the authority “to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act” and it could be considered an intermediate form of law-making. This confers quasi-legislative powers to the European Commission, however only if the “objectives, content, scope and duration of the delegation of powers shall be explicitly defined.”

The European Parliament and the European Council can each be allowed to revoke the delegation granted to the Commission if it is laid out in the legislative acts. Therefore, the legislative acts should provide for this revocation.

b) Implementing acts

Delegation under implementing acts is only envisaged in areas which do not fall within the scope of Article 290 TFEU. However, in contrast to Article 290, it allows the delegation of implementing powers in Union acts and is therefore not limited to delegations contained in the legislative acts.

Article 291 (1) makes it very clear that that the implementation is first and foremost the task of the Member States. It allows for implementation at the Union level only where uniform conditions for such implementation are needed. In contrast to Article 290 TFEU which entrusts control of the delegated acts to the Council and the European Parliament as the two institutions of the legislative authority, Member States are envisaged to hold the control mechanisms. The Commission therefore has to consult representatives from Member States through the Comitology system before the adoption of any implementing measures.

Appendices

Appendix 1 – Submission to the European Commission on a proposal for a revised EU ETS

Appendix 2 – Comments on the Dutch Emissions Authority proposal for a *Simple and Effective EU ETS*

Proposal for a revised EU ETS

Ibec, the group that represents Irish business, welcomes the opportunity to comment on the proposal for the review of the EU ETS post-2020. We speak for over 7000 member companies across a range of industrial, commercial and non-profit sectors: home grown, multinational, big and small, spanning every sector of the economy. The organisation strives for business conditions that enable sustainable, economic growth.

The impact of this proposal in securing a strong, competitive industrial base cannot be underestimated. Getting the revision of the ETS right is critical for the future viability of Irish based energy-intensive industries. If the ETS is to remain the main tool for least cost emissions reduction while promoting investments in low carbon technologies, it must address the loss of competitiveness through effective, evidence-based measures to prevent carbon leakage. The international scope of our members' markets reinforces the need for least cost reduction, and long-term protection against carbon leakage for the most efficient installations in the EU (especially while there is no global level playing field).

Summary of Ibec response/request for further clarification:

- 1) **Maintain the current benchmark methodology.**
- 2) **What is the basis for applying a 1% annual linear reduction as a one-size-fits-all approach? Technological efficiency improvements do not and have not developed at the same rate for all industries.**
- 3) **The arbitrary annual reduction in allowances could be prevented through the inclusion of flexibility in the amount of free allocation using a reserve or auction adjustment. This could be done whilst maintaining the overall cap on emissions and therefore preserve the environmental integrity of the EU ETS.**
- 4) **100% free allocation must be guaranteed for non-combustion (process) source stream emissions.**
- 5) **The “fall back” provision is not defined in the document. Clarification is sought on how similar products would be treated post-2020.**
- 6) **A more recent baseline (i.e. 2016-2019) and a shorter period is necessary to better reflect and take into account changes in production levels.**

- 7) The NACE-4 code will fail to recognise certain exposed sub-sectors. As a result, certain sub-sectors would be excluded from carbon leakage protection in spite of high levels of exposure to carbon leakage and intense international competition.
- 8) The European Commission Energy and Environment Aid Guidelines should be used as inspiration to strengthen the provision of compensation for indirect costs, using the cumulative combination of direct plus indirect emission intensity criteria. This will introduce a more uniform approach in the award of compensation thereby reducing the risk of distortion between member states.

The proposal must be modified in the following areas to provide adequate protection for sectors vulnerable to carbon leakage and avoid discouraging industrial investment within the EU.

Benchmarks and free allocation

What is proposed? *In broad terms, the benchmark values for free allocation will be adjusted in order to avoid windfall profits and reflect technological progress in the period between 2007-2008, and reduce by 1% each year thereafter (a different methodology will be applied if the benchmark values differ from the annual reduction by more than 0.5%, whether higher or lower.*

Summary of Ibec position:

- 1) Maintain the current benchmark methodology.
- 2) What is the basis for applying a 1% annual linear reduction as a one-size-fits-all approach? Technological efficiency improvements do not and have not developed at the same rate for all industries.
- 3) The arbitrary annual reduction in allowances could be prevented through the inclusion of flexibility in the amount of free allocation using a reserve or auction adjustment. This could be done whilst maintaining the overall cap on emissions and therefore preserve the environmental integrity of the EU ETS.
- 4) 100% free allocation must be guaranteed for non-combustion (process) source stream emissions.
- 5) The “fall back” provision is not defined in the document. Clarification is sought on how similar products would be treated post-2020.

Background

The proposed methodology does not adequately reflect the technological processes of different sectors and there does not seem to be a technological basis for the 1% reduction. Process emissions and combustion emissions need to be separated, as technological constraints in a number of sectors will limit the scope for reduction. Simply put, the manufacture of certain products cannot be made more efficient. For example, some sectors would be limited in type of fuel they can use, whether it is due to price, gas connection/network issues, and locational issues in terms of sourcing cheaper substitutes. For example, certain kilns used in the manufacture of cement or calcining lime are restricted to a limited number and type of fuels that they can use. Therefore, 100% free allocation must be guaranteed for non-combustion (process) source stream emissions.

According to our interpretation of the European Council conclusions of October 2014, there is a cap on the overall amount of allowances but not on the amount of free allowances. By assuming an approach with a fixed amount of auctioning, the Commission concludes that the number of free allowances is limited and must be reduced through a combined application of the cross-sectoral correction factor, a percentage-based reduction of the benchmarks and updating the historical activity level. This approach again creates legal uncertainty for energy-intensive industries as it fails to adequately address the European Council's request that the best performer should not bear undue carbon costs. The proposal suggests that exposed sectors will instead face a twofold linear limitation of the required carbon leakage protection, which induces additional costs for even the best performers. The emissions cap for the ETS could therefore be met by adjusting the auction amount or by the creation of a reserve.

Some products are not covered by a benchmark and come under the "fall back" provision. However, this provision is not defined in the document and we would welcome proposals outlining how similar products would be treated post-2020.

Allocation based on recent production data:

What is proposed? *Production levels for 2013-2017 and 2018-2022 will be used to inform and update allocation for 2021-2025 and 2026-2030 respectively.*

Summary of Ibec position:

- 6) A more recent baseline (i.e. 2016-2019) and a shorter period is necessary to better reflect and take into account changes in production levels.**

Background

The existing allocation system based on historical production has proven to be too rigid and distortive and a more dynamic allocation methodology is favoured. Recent production levels should be considered as an option for the allocation of free allowances in order to provide better protection against carbon leakage and to avoid problems

deriving from over or under allocation. However there are concerns about the revision period. A more recent baseline (i.e. 2016-2019) and a shorter period is necessary to better reflect and take into account changes in production levels.

To aid the data collection process, the European Commission should consider developing appropriate, user-friendly templates.

Carbon leakage

What is proposed? *There are new rules to define sectors at risk of carbon leakage. There is 100% of benchmark level for exposed based on quantitative and qualitative criteria and 30% of benchmark level for non-exposed. In a change to the current methodology, sectors will be categorised at NACE-4 level.*

Summary of Ibec position:

- 7) The NACE-4 code will fail to recognise certain exposed sub-sectors. As a result, certain sub-sectors would be excluded from carbon leakage protection in spite of high levels of exposure to carbon leakage and intense international competition.**

Background

While industry welcomes the recognition and provision of carbon leakage protection for energy-intensive industries, the treatment of certain sectors as a whole (i.e. NACE-4) will exclude certain sub-sectors from necessary protection levels. As the current legislative proposal anticipates determining carbon leakage eligibility at NACE-4 sector level, this would result in the exclusion of certain sub-sectors in the dairy industry.

Sustainable farming practices of the EU produce high quality food of low carbon. Penalising certain dairy sub-sectors could have the undesired effect of driving farming and dairy produce manufacturing outside the EU, contradicting the EU's goal of reducing overall emissions.

Indirect costs

What is proposed? *There is no harmonised approach for compensating indirect costs which remains at the discretion of member states. The proposal reinforces that rationale for member states to compensate, by replacing “may” with “should”.*

Summary of Ibec position:

- 8) The European Commission Energy and Environment Aid Guidelines should be used as inspiration to strengthen the provision of compensation for**

indirect costs, using the cumulative combination of direct plus indirect emission intensity criteria. This will introduce a more uniform approach in the award of compensation thereby reducing the risk of distortion between member states.

Background

Energy-intensive industries do not appear to be on a level playing field for indirect costs. Therefore some member states will provide compensation while others will not, contravening the fundamental principle of common treatment regardless of location within the EU.

Comments on Dutch Emissions Authority proposal for a *Simple and Effective EU ETS*

Strategies 1, 3 & 5 - reporting and compliance procedures, verification and monitoring

The goal of making monitoring simpler for small proposed emitters and more efficient for all participants was on the whole welcomed i.e replacing the monitoring plan by generic European rules defining how an emissions report should be compiled. However, as noted by one of our members, the difficulty with simplifying the monitoring, reporting or verification process is that fuel type, equipment, and standards vary across industry. Therefore finding a generic template or approach that suits all is more difficult. Any changes to the assessment criteria could lead to a change in emissions figures which may have implications for ETS and non-ETS sectors. Individually the emissions from a small emitter are relatively small, but cumulative they may have an impact on national figures.

There is a precedent for simplification, the UK operated an opt-out scheme for small emitters and hospitals and there has been a simplification of process for small emitters within the aviation aspect of ETS (simplified monitoring and reporting). The problem is that aviation is far more homogenous with one fuel source and a similar combustion process across the industry.

One member stated how they are obliged to have emissions verified by an EPA approved verifier and at their cost. However, each year, circa 3 or 4 months after submitting their calculated figures and surrendering the corresponding allowances, the EPA will revert with “pages” of queries on calculated and verified emissions. This generally requires a lot of time and has never led to a change in the figure. While it is of course guided by European Commission rules, it would appear that the EPA do not accept the verification and therefore renders the exercise redundant.

Furthermore, other comments echoed this i.e. too much emphasis currently of audits, risk assessments etc. when > 98% is from customer bills or only one major source of emission.

Strategy 2: allocation

Suggestions to shorter allocation periods may be of benefit but only for certain sectors. A more pragmatic approach to dealing with changes would make a lot of sense; especially for installations with multiple products under the one roof. Changes regarding the broader application of product benchmarks could have important implications, especially for companies currently under the “fall back provision”. However, it is important to point out that a number of companies currently under the “fall back provision” (dairy, some of the niche building materials companies based in Ireland) have not provided input on what the Dutch proposals would mean for them. It is also important to point out that the “fall-back provision” is not set to change and if the Commission is to be believed, is “extremely generous”.

The proposal for product benchmarks and/or the widened applicability of the existing product benchmarks specifically points to the food sector as a good candidate for further product benchmark development, particularly for dairy products. Instead of allocating free allowances for a period of eight years, an allocation might be valid for just two or three years.

However, the suggestion that carbon leakage status could be defined exclusively at the sector level, not at the sub-sector or product level (NACE codes only) could have negative implications for the dairy sector. While the European Commission proposal would provide the qualitative route for full carbon leakage protection, they are still to crunch the numbers to see if they could qualify. The Dutch proposal says that existing rules state that companies that combine production that is carbon leakage exposed with production that is not carbon leakage exposed can treat their entire production as carbon leakage exposed if less than 5 per cent is not liable to carbon leakage. If the lower limit were increased to, for

example, 20 per cent, a smaller number of companies would qualify as combining the two categories of production.

According to comments received from the dairy sector, the lower limit must be 20% minimum or else of little use to them, should be based on current products rather than possible changes in 2019.

Strategy 4: registry

On strategy 4 regarding the registry and more proportionality in security measures, there was agreement with the proposal as asking for the re-registering details every 2 years for same person is disproportionate. However, it was also noted how security requirements (credit checks, financial sanctions lists, proof of address, EU bank accounts, utility bills etc) were increased in response to instances of fraud and money laundering. There could be an issue if lower standards for small emitters in terms of removing or easing the reporting/verification requirement coupled with lesser security for registry users, resulted in the creation of dummy entities for the purpose of money laundering or fraud.

However, the likelihood that a compliance account would be used for such activities is far less than that of a trading account, so there should be some scope for a lowering of the security requirements for compliance accounts in the registry.

Strategy 7: participation

Companies with installed capacity of more than 20 MWth have to participate in the ETS, even if their emissions are very low, while other companies, which make intensive use of lower installed capacities, do not have to participate, even if they produce higher emissions. Therefore it suggests that a greenhouse gas emissions threshold should be adopted as the primary criterion for participation. While this was accepted as a sensible approach I did not receive any substantive comments.

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