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Government's Response to Consultation on Commission's proposals to amend the EU Emissions Trading Scheme from 2013

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and Climate Change**


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Government response

1. This consultation has provided valuable information about stakeholder opinions of the European Commission's proposed amendments to the EU ETS Directive (2003/97/EC) and informed the Government's¹ thinking on the main issues. The UK is a strong supporter of the EU Emissions Trading System as a central means to drive cost-effective and ambitious emission reductions. It is encouraging to note that there is much agreement between stakeholders and the Government on the majority of issues. The Government takes careful note of the points respondents have made, and will take them into account in its discussions with its European counterparts in the negotiations on the Directive.
2. In response to stakeholders' views, we set out here the Government's position on the key issues under discussion on the revised Directive.
3. We support the Commission's proposal for an **EU-wide central cap** with a clear linear downwards trajectory to 2020 and beyond, of 1.74% annually under the EU's 20% greenhouse gas target. This will maintain the environmental integrity of the system, increase its effectiveness and ensure greater predictability for investors. Stakeholders on the whole either agreed with this view or considered the proposed level of the cap to be too low.
4. On the question of the adjustment of the EU ETS cap to meet a 30% GHG target, a number of respondents felt that any response from the EU should depend on the quality (definition and environmental ambition) of the agreement. The Government believes it is important to show the rest of the world that the EU is committed to delivering a 30% emissions reduction by 2020 as part of an international climate change agreement. We therefore continue to favour the **automatic adjustment of the EU ETS cap to meet**

¹ Implementation of the EU ETS is a devolved matter and the Devolved Administrations of Scotland, Wales and Northern Ireland are involved throughout the decision-making process.

the GHG target of a reduction of up to 30% when the EU ratifies a future international climate agreement for post-2012. However, at present, it is unclear whether this automatic adjustment is negotiable or whether we will need a new co-decision by the Council and the European Parliament after an international agreement is reached.

5. The Government believes that a global carbon market is essential to deliver on the challenge of mitigating emissions worldwide, by putting a price on carbon and engaging private investment and initiative in mitigation at the scale necessary to deliver substantial reductions. For this reason Government supports an outward facing emissions trading system which seeks to catalyse broader and deeper participation in the market by key countries and key sources of emissions. The Government agrees with those who said that the EU must demonstrate it is serious about the transition to a low carbon economy through emission reductions within its borders. Europe should not rely disproportionately on third countries to meet its targets. The Government therefore believes that access to **project credits** at an EU level in both the EU ETS and the non-traded sector should be limited so that at least 50% of absolute emissions reductions compared to 2005 to take place within the EU. The Government agrees with respondents that provision should be made for greater harmonisation of project credit limits in Phase III.
6. On auctioning levels, respondents tended to support **a significant increase in auctioning in Phase III**. In particular, the Government intends to auction 100% to the power sector from 2013. More generally, we understand industry concerns that minimum levels of auctioning could mean different levels between Member States. It is important, however, that the scheme allows Member States the flexibility to adopt higher levels of auctioning should they wish, for example to avoid windfalls in particular sectors and to allow Member States more control over revenue streams, provided intra-EU competition is not significantly affected.
7. The Government recognises the importance of addressing **carbon leakage**, and understands that this is the key issue for many industries. We have developed detailed criteria for assessing the risk of carbon leakage (i.e. an

evidence-based approach), and we are also building support for bringing forward the timetable for identifying which sectors are at significant risk, in line with many respondents' preferences. The Government continues to believe that the best solution is a comprehensive international agreement on climate change. However, in the absence of such an agreement action will be needed. Of the possible solutions, the Government favours the allocation of free allowances to sectors at significant risk.

8. For sectors that are shown to be at significant risk of carbon leakage because they face high indirect costs (i.e. increases in production costs from higher electricity prices resulting from the EU ETS), the Government believes the Directive should provide, in principle, for measures to address them. These measures should only be taken in the absence of a comprehensive international climate change agreement and if there is robust evidence demonstrating that a sector is at significant risk of carbon leakage because of indirect costs. Any free allocation must not lead to an increase in the total number of free allowances or a reduction in the number to be auctioned. Our initial analysis indicates that in the UK indirect costs would only be an issue for a very limited number of installations.
9. The Commission's proposal that **on-site production of electricity should face 100% auctioning in Phase III** was an important issue for many, and opinion was divided. Although the Government understands the concerns of those who favour free allowances, including for electricity produced by Combined Heat and Power, it believes this would distort competition in the energy market. We therefore support the Commission's proposal. We recognise that Combined Heat and Power delivers carbon savings and will consider how those savings can be recognised through the allocation methodology.
10. Similarly, on the issue of the use of **waste process gases** for on-site electricity generation, the Government agrees with the Commission's decision not to propose free allocation for electricity production. The Government does recognise that the efficient use of waste gases could be taken into account as an 'efficient technique' when determining sectoral benchmarks. This would

depend on evidence that this incentivised the efficient use of energy and avoided perverse incentives to increase emissions.

11. On **hypothecation** (also known as earmarking), the Government is opposed to the Commission's proposal that a proportion of auctioning revenue should be dedicated to climate change measures. Whilst earmarking clearly appeals to many stakeholders, it is an inefficient means of determining public expenditure priorities which should generally be looked at in the round rather than by creating artificial links between particular spending programmes and specific revenue streams. Moreover, it is inappropriate for EC legislation to determine national public expenditure allocations, for which national governments are responsible and accountable to their national parliaments. Mandatory hypothecation at an EU level therefore runs counter to the principle of subsidiarity, which the Government strongly supports. At the same time, the Government is providing financial support for a range of climate change measures, and is working towards a significant increase in global climate financing in the international climate change negotiations.

12. Most respondents took the view that climate change related financial assistance for new Member States should be treated as an issue for the EU Budget and associated measures such as the Structural Funds, and not through environmental legislation. The Government maintains its opposition to the **redistribution (or reweighting towards less wealthy Member States) of auction rights in the EU ETS.**

13. **Carbon dioxide capture and storage (CCS)** has the potential to reduce carbon dioxide emissions from fossil fuel power stations by as much as 90% and, as highlighted in the Stern Review, the potential to contribute up to 28% of global CO₂ mitigation by 2050. The Government strongly supports the demonstration of CCS. In order to finance up to 12 demonstration projects (the number agreed by EU Heads of State), the Government supports the proposal from the European Parliament to use EU ETS allowances from the New Entrant Reserve (NER). We also welcome the Commission's proposal that CCS be included in Phase III of the EU ETS as a means of incentivising demonstration and deployment of CCS across the EU. As such, the

Government is encouraged that the consultation responses demonstrated very strong support for the Commission's proposal to include CCS in the EU ETS from 2013.

14. On **small emitters**, the first two phases of the scheme have highlighted the disproportionate costs of inclusion in the scheme relative to emissions for some of the smallest installations. The Government has supported the exclusion of installations emitting less than 25,000 tonnes CO₂ per annum, provided equivalent measures for emissions reductions are in place. This would provide the best balance between emissions reduction and lowering the administrative burden, and respondents to the consultation provided moderately strong support for this position. The proposed thermal input threshold of 25MW is, in the Government's view, unnecessary and could adversely affect institutions such as hospitals and universities which may own high-capacity equipment but make only occasional (e.g. seasonal) use of it.

15. There was support in the consultation responses for the Commission's proposal for an **EU-wide New Entrant Reserve (NER)**. This matches the Government's view. A central NER would be consistent with a central cap and would prevent competitive distortions between Member States. On the Commission's proposal for an NER of 5% of the overall EU cap, there was strong support for the Government's view that this level may be too high. A considerable number of respondents favoured the Government's position that a reserve of only 1.2% is necessary for new entrants and expansions in Phase III. There was also strong support for the Government's view that installations which close should not receive further free allowances. However, there was considerable disagreement with the Commission's definition of a new entrant, and the UK and several other Member States are pressing for a definition which allows allocation for significant expansions of existing installations.

16. The Government welcomes respondents' support for the Commission's proposals on **linking to other carbon trading systems**. This will help us make progress towards the vital goal of a wider global carbon market, while

safeguarding the stability and robustness of the EU ETS – the importance of which respondents highlighted.

17. On the issue of **auction design**, almost all respondents to the question agreed with the Government (and the Commission) that there was a need to ensure auctions are open, transparent and non-discriminatory. The Government will continue to work closely with the business community to ensure these objectives are met when the detailed arrangements are being developed and implemented.

Next Steps

18. Many of the issues on which respondents commented are the subject of the current negotiations between the EU Member States, the European Parliament and the European Commission. The negotiations are progressing rapidly and Member States' positions continue to evolve. The Government strongly supports the Presidency's aim of concluding the negotiations this year, with a First Reading agreement on the revised Directive in December 2008. A delay could mean that the Directive would not be agreed before the international climate summit in Copenhagen (in late 2009).

19. Once the revised EU ETS Directive is agreed, further work will be necessary to agree many of the details of the system from 2013, including benchmarks for free allocation, rules for new entrants and closures, auction design, carbon leakage measures and monitoring, reporting and verification issues. Creating the right incentives for business to reduce greenhouse gas emissions will remain a central Government objective, as will harmonisation across Europe of appropriate aspects of the system's implementing measures. We will continue to consult and listen to UK stakeholders on these important issues.