

## IETA's views on activity-based allocation

Allocating free allowances to sectors considered at risk of carbon leakage is an important part of the ETS revision proposal for Phase IV. As there will be fewer allowances in Phase IV, the question of *how* to allocate the available free allowances becomes important. Free allocation is based on the benchmark level for the relevant product or activity and production levels. A discussion is currently taking place amongst market participants and policy makers on the extent to which free allocation should be more closely linked to real activity and production levels rather than using historical activity levels.

In light of the ongoing discussions, IETA proposes some reflections that should be taken into account, should policy makers choose to establish an allocation system that is more closely aligned to recent production levels.

An activity-based allocation does not put into question the basic design of a cap and trade system. Setting an absolute, binding, and EU-wide cap is an essential design element of the EU ETS and needs to be maintained to ensure the environmental target is respected.

Moreover, within this absolute EU-wide cap, a predefined share of allowances will be auctioned. This therefore implies a cap on free allocation. As a result, a cross-sectoral-correction factor (CSCF) will apply if the total amount of free allowances exceeds the share of free allocation foreseen in the ETS Directive. As the CSCF applies evenly to all sectors, it is perceived as an inflexible and indiscriminate measure as it cuts free allocation regardless of the characteristics of respective industrial sectors in terms of their risk of carbon leakage. Consequently, minimising the application of a CSCF is an important consideration in the revision of the EU ETS for Phase IV. Activity-based allocation can help avoid over-allocation of free allowances, which in turn can help minimise the need to apply a CSCF.

### **Current European Commission proposal**

The proposal by the European Commission for Phase IV foresees two allocation periods that use updated activity data halfway through Phase IV, thereby shortening the allocation period duration from 8 years in Phase III to 5 years. However, the timelag has not decreased significantly between the production data used and the time when



allowances are allocated, as it corresponds to the average annual production from the previous 8-12 years. Moreover, free allocation will also vary according to production increases or decreases – the thresholds are not specified in the ETS Directive but this potentially could represent an additional source of flexibility for allocation based on ‘real’ activity levels.

*Allocation = **activity level** x benchmark value x carbon leakage factor x correction factor*

There are two distinct proposals to better align free allocation with production data:

- **Activity-based allocation:** Reduce the timelag between allocation of free allowances and the production data used to determine the level of allocation. There are two options for this reduced timelag:
  - Use more recent production data to justify annual changes in allocation (eg y-1 previous year data or y-2 data from the two previous years) – factoring time taken to collect and verify data<sup>1</sup>
  - Use a rolling average of production data from the previous years (eg a rolling average of the production data from recent years).
- **NER thresholds:** Introduce lower thresholds for changes in activity levels to trigger adjustments to free allocation from the NER.

### **Activity-based allocation: Why is it being considered?**

Basing free allocation on historic production data can lead to a mismatch between actual emissions and allocation: any change in activity level is not reflected in a change in free allocation. As a result, when production decreases, there is a risk of over-allocation; and when production increases, there is a risk of under-allocation. Given the total amount of free allocation has historically been reduced across all installations by the application of a Cross Sectoral Correction Factor (CSCF), over-allocation is seen as unfair and a poor use of free allocation to mitigate carbon leakage.

A sector receives free allowances to ensure it is not at risk of carbon leakage, but if that compensation is greater than its emissions, the over-allocation is difficult to justify, especially if it leads to application of a CSCF across all sectors. Activity-based allocation

---

<sup>1</sup> The exact time lag will depend on the data collection procedure that is agreed. Based on today’s procedure, the earliest full year’s worth of data that could be used for 2025 for example, would be 2023 or even 2022; but 2024 data would not be available.



would target those sectors most exposed to the risks of carbon leakage, and adequately compensate them and reduce the need to enforce a CSCF going forward.

A better alignment of allocation with more recent production data can help minimise such risks and ensure allocation is distributed to reflect “real” needs of what is being produced and avoid a risk of under-allocation or over-allocation.

### **What needs to be considered?**

- **Incentives to reduce emissions**

Continuing with the benchmark approach is essential to maintain incentives to reduce GHG emissions. Activity-based allocation does not change the importance of the benchmark, and its role in driving emission reductions and improved performance.

- **Predictability considerations**

As the data would be updated regularly, this creates a lack of predictability on whether or not a CSCF will apply within a Phase. Such information would only become available once the initial activity data has been aggregated and verified. However it would give an indication as to how close allocation was to the CSCF application for the remainder of the Phase.

### **Reporting requirements**

In addition to emissions data being verified, installations must also submit their activity data to be verified. Both small and large installations already have to report and submit this data, so there is no extra burden for installations. Since verifiers are accredited by Member States and via a European Accreditation system, further checks are discretionary for the competent authority and/or the European Commission. A harmonised common reporting format and data language would also assist national and Commission data collection and processing. Paper-based reporting and accreditation systems are inefficient, bureaucratic, slow, costly, and thus unacceptable in Phase IV of the EU ETS.

### **NER thresholds**



A report<sup>2</sup> by Ecofys notes that administrative costs for reporting production adjustments depend on the threshold level used to determine significant production changes each year. The chosen threshold will affect the number of times installations have to report significant production changes and will impact the capacity needed in the competent authorities and the European Commission to deal with these notifications.

Consideration needs to be given to the number of adjustments that would be required and the number of installations affected. If adjustments are foreseen for annual changes in production levels for all ETS installations, there are concerns regarding the administrative burden that would affect competent authorities' ability to verify the data and adapt the allocation levels in time (evidence to date shows existing delays by some Member States in allocating allowances to installations by the 28 February deadline). Another possibility would be to consider a rolling average of production levels, to justify changes in allocation levels if there is evidence of production changes over recent years.

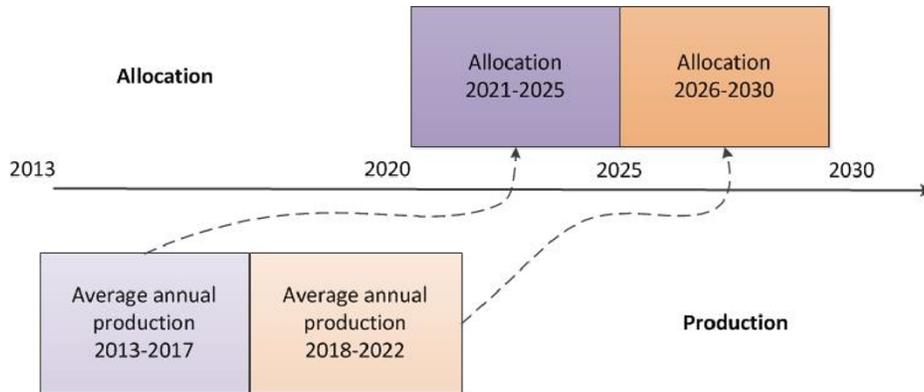
We note that a non-paper proposed by Austria, and amendments tabled in the draft Environment Report favour moving back the date for free allocation and compliance, to allow more time for administration.

**To what extent does the proposal for the ETS revision take into account these considerations?**

The proposal by the European Commission for Phase IV foresees two allocation periods that use updated activity data half way through Phase IV, thereby shortening the allocation period from 8 years in Phase III to 5 years. However the timelag has not decreased significantly between the production data used and the time when allowances are allocated, as highlighted in the graph below.

---

<sup>2</sup> <http://www.ecofys.com/files/files/impact-eu-ets-phase-iv-proposals-on-admin-costs-final.pdf>



*Source: February 2016 Commission Reply to questions from delegations concerning better alignment of free allocations with production levels*

Free allocation will also vary according to production increases or decreases – the thresholds are not specified in the ETS Directive but this potentially could represent an additional source of flexibility for allocation based on ‘real’ activity levels.

IETA recommends that more recent installation activity data should be used to determine the allocation of free allowances, in order to avoid structural under or over-allocation due to ex-ante estimation of future activity.

15 September 2016