

Feedback on the draft implementing regulation laying down arrangements for the adjustments to free allocation of emission allowances due to activity level changes

The European Roundtable on Climate Change and Sustainable Transition (ERCST) welcomes the opportunity to provide feedback to the draft implementing regulation laying down the arrangements for the adjustments to free allocation of emission allowances due to activity level changes.

Developing robust rules for dynamic free allocation is an important piece of the puzzle in making the EU ETS function properly, as it ensures better alignment between the supply and demand of free allowances and limits the risk of under- or oversupplying installations that are perceptive to carbon leakage, thus reducing the risk to both carbon leakage and windfall profits.

ERCST believes that the level of free allocation should resemble activity levels as closely as possible. The rules on free allocation adjustments should be made as dynamic as possible. This does not only translate in the fact that free allocation adjustments should proportionately follow changes in activity levels, but also means that the time-lag between measuring activity levels and applying adjustments should be as short as possible.

The draft implementation regulation should be welcomed as an important step forward in the process towards robust dynamic free allocation rules. ERCST especially wants to highlight and express its support for the following provisions:

1. The requirement for installations to *annually* report their activity level data, with the first year being 2021, covering the data for 2019 and 2020;
2. The proposed arrangements for ‘other changes in the operation of the installation’, which will address the issue for installations using fall-back benchmarks such as heat and fuel consumption. These arrangements will ensure that efficiency gains are not punished, or efficiency losses rewarded;
3. The inclusion of the provision that when activity levels are reported to be zero, free allocation is set to zero immediately the following year without needing to take into consideration a two-year rolling average.

However, in ERCST’s opinion, the draft implementing regulation includes some issues that should be clarified and shortcomings that should be addressed.

1. Timing of adjustments

Article 5(1) of the draft regulation states that “*the adjustment shall apply as of the year following the two calendar years used to determining the average activity level*”. We understand this to mean that free allocation in e.g. 2021 shall be based on the comparison between the average activity level data of 2019-2020, being the two previous calendar years, with the historical allocation level (HAL).

However, article 3(3) states that activity level reports shall be submitted by March 31, which is after the deadline of February 28 for Member States to allocate free allowances, as stipulated by Article

11(2) of Directive 2003/87/EC. As such, it is unclear how the adjustment will be made ‘in the year following the two calendar years used to determine the average activity level’. If the deadline for allocating free allowances is not pushed back, the only way adjustments can be made would be through a ‘true-up mechanism’, correcting the amount of free allowances initially allocated. If this is indeed the case, additional provisions should be included in the implementing regulation how this will take place in practice.

If this is not the case, and the actual adjustments are only made the year afterwards, the reaction time for the system to respond to changing activity levels or changing economic conditions would be significantly undermined. This should be avoided at all costs.

We are aware that these issues will for some extent be left at the discretion of the Member States, as is currently already the case (e.g. differences between Member States exist with regard to the timing of handing out free allocation in practice and the timing of applying adjustments). However, some general guidelines could be welcome.

A promising mechanism which is under consideration in at least one Member State is a two-step approach: installations would in January be invited to report their (unverified) activity levels to the regulator. In case the activity level is *at least as high* as the previous two-year rolling average, they will receive their free allocation before February 28. After verifying the activity data and the new two-year rolling average is calculated, any additional free allocation is given by March 31, if necessary.

Installations that report decreased activity levels or do not report their activity levels would not receive any free allocation by February 28, but only by March 31, after the verification. This distinction is necessary as it proves to be legally difficult to claim back free allowances once handed out.

2. Adjustments in practice

Following Directive 2003/87/EC, the first adjustment will take place when a relative threshold of 15% increase or decrease is reached. The implementing regulation states that subsequent adjustments will only take place when an interval of 5% (beyond the initial 15%) is reached – interestingly, the adjustment will be *‘the exact percentage change in the average activity level’*.

In practice, for installations that have already passed the 15% threshold, a subsequent increase of the rolling average activity level to for example 19% compared to the HAL would not result in an additional change to the installation’s free allocation, while a subsequent increase to for example 21% would result in exactly a 21% change.

It is worth noting that this method was not an option given during the public consultation held earlier this year. What is proposed seems to be a hybrid method, or compromise, between the linear and staged approaches taken into consideration in the consultation.

Preamble (7) highlights that the rationale for these rules is to prevent manipulation or abuse of the system, and avoid undue administrative burden. ERCST wants to remind the Commission that the use of the 5% intervals, contrary to the linear approach, creates room for operators to abuse (to a limited extent) the system.

Moreover, we fail to see how this approach would contribute to reducing the administrative burden, unless there is a lack of IT capabilities to process the amount of changes. ERCST is of the opinion that, if this is indeed the case, this lack of IT capabilities should be addressed rather than making the system more complex and less dynamic.

ERCST wants to stress that, while the approach included in the draft implementing regulation is preferential over any of the staged approaches included in the public consultation, a full linear approach is the most dynamic and thus the preferred option. ERCST wants to remind the European Commission that this preference is shared by a large majority of stakeholders who responded to the public consultation.

3. Absolute quantitative threshold

Unfortunately, no additional ‘absolute quantitative threshold’, above which allocation changes would take place independently of the 15% relative threshold being reached or not, is included in the draft implementing legislation. This ‘or condition’ next to the 15% relative threshold was suggested by a large group of stakeholders in the public consultation, including ERCST.

ERCST regrets that the Commission does foresee a minimum absolute quantitative threshold of 100 allowances, but not a maximum one. This is a missed opportunity to make the system more dynamic. Indeed, the exclusion of such an additional threshold implies that (especially) larger installations are at risk to be considerably under- or over allocated (in absolute terms) before an adjustment to free allocation is carried out. Moreover, the exclusion of an additional threshold also increases the risk of manipulation or abuse of the system.

4. Other changes in the operation of the installation

While the provisions included in article 6 for the fall-back benchmarks can be supported, ERCST would like to stress that the requirement to demonstrate that the change in activity levels does (not) relate to a change in production levels should be *mandatory* for both increases and decreases in activity levels.

Article 6(2), for activity level increases, is currently formulated in a way that seems to imply that the operator should only demonstrate this if it is requested to do so (“upon request”). ERCST advises to rephrase this paragraph to make it mandatory for operators to prove this, as operators of which the sub-installation’s activity level increased have no incentive to demonstrate that this change is related to an increase in production levels, and not caused by a decrease in efficiency.

On the contrary, such an incentive does exist for operators whose sub-installation’s activity decreases.

5. Installations that resume activities following ‘zero activity’ year(s)

It is necessary to highlight an issue for installations that resume their activities after a year where the activity level was reported as zero: given the method of two year rolling averages, installations are in risk of being undercompensated in the year they resume activities. The implementing act should introduce a provision that addresses this issue. One possibility would be to regard the years where activity levels were reported to be zero as ‘leap years’: these years would not count towards

calculating the two-year rolling average for the year when the installation resumes its activity. Operators should also announce beforehand the intention to restart an installation's activities.

Conclusion

In conclusion, ERCST welcomes the draft implementation regulation as an important step forward in the process towards robust dynamic free allocation rules for Phase 4 of the EU ETS. However, going forward, we believe that five important issues should be clarified or considered to be included in the final regulation:

1. Clarify the timing of free allocation adjustments, and how this will take place in practice, reflecting the provision that *'the adjustment shall apply as of the year following the two calendar years used to determining the average activity level'* captured in Article 5(1);
2. Reconsider the use of full linear approach for free allocation adjustments beyond the initial 15% threshold;
3. Reconsider the inclusion of an additional 'absolute quantitative threshold' to adjust free allocation to increase the flexibility of the system and reduce the risk to both carbon leakage concerns and windfall profits;
4. Make it mandatory for operators of sub-installations using fall-back benchmarks to demonstrate whether or not a change in activity levels is related to a change of production levels or not.
5. Introduce provisions which ensure that installations that resume their activities following 'zero activity' year(s) are not under allocated.