

CICERO Working Paper 2008:01

The European electricity sector and the EU ETS review

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March 2008

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Titel: The European electricity sector and the EU ETS review

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CICERO Working Paper 2008:01
11 sider

Finansieringskilde: EU

Prosjekt: ADAM: Adaptation and Mitigation

Prosjektleder: Gunnar Eskeland

Kvalitetsansvarlig: Tora Skodvin

Nøkkelord: EU, el-sektor, kvotehandel

Sammendrag:.

Title: The European electricity sector and the EU ETS review

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CICERO Working Paper 2008:01
11 pages

Financed by: EU

Project: ADAM: Adaptation and Mitigation

Project manager: Gunnar Eskeland

Quality manager: Tora Skodvin

Keywords: EU, electricity, emissions trading

Abstract:

The European Union Emissions Trading Scheme (EU ETS) has been reviewed and evaluated, and this paper surveys the positions of electricity producers and consumers on the review of the EU ETS. More specifically, the paper examines the positions of electricity producers and consumers on cap-setting and allocation method and discusses to what extent the views of electricity producers and consumers reflected in the Commission's proposal for changes in the Directive on emissions trading. The paper finds that the Commission's proposal is not in line with the positions of the electricity producers. The electricity sector is the only sector – together with carbon capture and storage – where the principle of auctioning is applied from 2013. Nor did the electricity-producing sector succeed in getting an equal burden-sharing between the trading and non-trading sectors. The alliance of energy-intensive industries was far more successful as the Commission's proposal opens for free quotas, alternatively a carbon equalisation system in the energy-intensive sector.

Språk: Engelsk

Language of report: English

Rapporten kan bestilles fra:
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P.B. 1129 Blindern
0318 Oslo

The report may be ordered from:
CICERO (Center for International Climate and
Environmental Research – Oslo)
PO Box 1129 Blindern
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1 Introduction

The European Union (EU) is committed to reducing the EU-15's greenhouse gas emissions by 8 percent below 1990 levels in the first Kyoto period (2008-2012).¹ The EU emissions trading system (EU ETS) is a cornerstone in EU's efforts to fulfil its Kyoto commitments. The EU ETS covers 12,000 large energy-intensive plants representing 43 percent of the EU's total emissions – mainly power generation and energy-intensive industries. The plants are found in five sectors: electricity (and heat) production, iron and steel, oil and gas, building materials (cement, glass, ceramics and bricks) and finally, pulp and paper.

In March 2007, the European Council decided to reduce their greenhouse gas emissions by 20 percent by 2020. One of the main policy instruments to meet this aim was the EU ETS. The EU ETS has been reviewed and evaluated, and this paper surveys the positions of electricity producers and consumers on the review of the EU ETS – more specifically, on the two questions of how the cap is to be set and the choice of allocation method in the third trading period, starting in 2013.

The paper aims to answer two questions:

1. What are the positions of electricity producers and consumers on cap-setting and allocation method?
2. To what extent are the views of electricity producers and consumers reflected in the Commission's proposal for changes in the Directive on emissions trading?

The next section accounts for the background of the EU ETS. Section three explains the EU ETS review process, section four focuses on the stakeholders' position on cap-setting, and section five accounts for the stakeholders' position on allocation method. The sixth section accounts for the Commission's proposal for changes in the EU ETS post-2012, and the seventh section concludes.

2 The EU emissions trading system

The Commission proposed an EU carbon/energy tax in the early 1990s. This tax was intended to be a cornerstone of the EU climate policy (Christiansen and Wettestad 2003:6). The tax met strong opposition from the industry and key member states, and the necessary consensus in the Council of Finance Ministers was never achieved (ibid). This tax was transformed into a tax on mineral oil, and focus shifted to emissions trading. Directive 2003/87/EC establishes a scheme for greenhouse gas emission allowance trading within the EU, and it is the emissions trading system (ETS) which is now the cornerstone of EU's efforts to reduce greenhouse gas emissions.

There were many choices to be made before the EU ETS Directive was adopted. Markussen and Svendsen (2005) focused on four groups of issues: 1) Target group: the sector to be covered by the scheme, 2) allocation method: auctioning versus grandfathering, 3) mix with other instruments: emissions trading is considered as domestic action, project-based emissions reductions and links to other emissions trading systems are treated as supplementary to domestic action, and 4) compliance: mainly focusing on the penalty size. However, Christiansen and Wettestad considered the question of mandatory or voluntary participation in the first trading period from 2005-2007 as the most contentious issue (2003:13). They emphasised the German industry's opposition to a mandatory scheme.

¹ The EU had 15 member states when the Kyoto Protocol was negotiated.

Svendsen and Vesterdal (2003:1532) argued that the electricity sector was best suited of all sectors to be covered by the EU ETS because the electricity sector was responsible for one third of the total CO₂ emissions in the EU (EU 1999), because of the many low-cost CO₂ emission reductions opportunities that existed within the sector, because the companies were relatively well-informed of the overall opportunities to reduce CO₂ emissions in the market – which would lead to early trading – and finally, because the sector was already tightly regulated.

According to the Directive, the EU ETS is mandatory, and the cap is set at the national level. The allowances are allocated for a period through the National Allocation Plans (NAPs). The member states then distribute the allowances among existing installations and potential new entrants through these NAPs. The emission cap is defined for each individual plant by the national government, and is based on the EU burden sharing agreement. The national allocation plans have to be accepted by the Commission.

The first trading period runs from 2005 to 2007. The second trading period coincides with the first Kyoto period – 2008 to 2012. The third trading period starts in 2013, and the length of this and the following trading periods is the object of discussion in the EU ETS review.

3 The EU ETS review process

Responding to Article 30 of the Directive, the European Commission submitted a report to the European Parliament (EP) and the Council evaluating the functioning of the EU ETS in November 2006. Stakeholders were invited to participate in a web survey before the Commission's review report was drafted by the Commission. The report identifies four strategic issues: 1) The scope of the EU ETS, 2) robust compliance and enforcement, 3) further harmonisation and increased predictability, and 4) linking with emission trading schemes in third countries (European Commission 2006). This paper focuses on the question of harmonisation. According to the Commission's report on the EU ETS to the EP, the EU ETS review "will explore the option of a single EU-wide cap and that of separate national caps after 2012 determined by each Member State, and will explore specific issues related to auctioning and benchmarking" (European Commission 2006:8). Hence, cap-setting and the allocation process were among the issues singled out as key strategic issues by the Commission.

The Directorate General Environment (DG Environment) ordered a web survey and a report on stakeholders' views on the EU ETS. The survey was conducted by McKinsey and Ecofys in the period June 2005-July 2006. The survey was open to all stakeholders, and log-in data was sent to 517 companies, government bodies, industry associations, market intermediaries and non-governmental organizations (NGOs) (DG Environment 2006: 3). A total of 302 organisations responded. Of those that responded, 51% were companies, 25% associations, 11% NGOs, 7% government bodies, and 6% market intermediaries (ibid). This is approximately twice as high as the number of responses received by DG Environment in the stakeholders' process on EU climate policy post 2012 (the process leading to the report "Winning the battle against global climate change").²

Further consultations were held in 2007 under the European Climate Change Programme (ECCP).³ The Working Group on the Review of the EU ETS held four meetings, focusing on

² The stakeholders' process on "Winning the battle against global climate change" was, however, based on position papers, not a web-survey.

³ The Commission launched the ECCP in June 2000 to identify and develop an EU strategy to implement the Kyoto Protocol. A second ECCP followed in 2005.

the four issues mentioned above. The group comprised representatives of Member States, industry, NGOs as well as academia and research. Figure 1 shows the number of participants representing industry and environmental organisations. Industry is divided into electricity producers (conventional and renewable power generators), electricity producers, energy consumers and BusinessEurope (cross sector business association). The figure shows the number of participants on the four EU ETS review meetings.

Figure 1. Number of participants representing different sectors at the four meetings arranged by the Working Group on the EU ETS Review

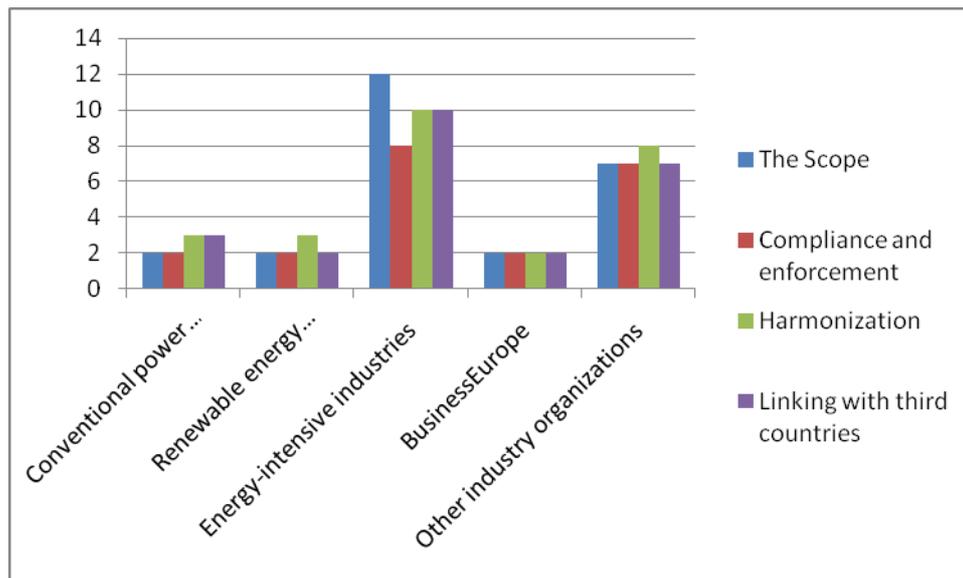


Figure 1 shows that electricity consumers were well-represented in the process. While conventional power generators sent 2-3 participants at the meetings, energy-intensive industries sent 8-12 representatives – in addition to the 2 participants from BusinessEurope. The renewable electricity industry (European Wind Energy Association and European Renewable Energy Council) was represented by 2-3 participants.

Many stakeholders also submitted their views on the review of the EU ETS during the summer 2007. A total of 49 position papers were submitted in June/July 2007 on the EU ETS review. These position papers are available online (DG Environment 2007).⁴ Unless otherwise stated, all references to stakeholders' positions in this working paper refer to these position papers.

In addition to the open stakeholders' process on the EU ETS review, the High Level Working Group on Competitiveness, Energy and Environment, set up by the Commission on the basis of a Communication on Industrial Policy, was engaged in the EU ETS review process. This group gave privileged access to a selected number of stakeholders. The 18 members of the group took part on a personal basis. Both electricity producers and consumers were well-represented in the group. The EU ETS review was one of the main subjects to be addressed by the group which had a mandate of two years.

The EU ETS review resulted in a legislative proposal. The proposal was originally to be adapted by the Commission by the end of 2007, but postponed to 23 January 2008. The legislative proposal was presented as part of the Commission's "Climate action and

⁴ However, two of the positions are not public.

renewable energy package” which also consisted of a proposal on burden-sharing between the Member States with regard to the non-trading sectors and a directive on the geological storage of carbon dioxide.

4 Stakeholders’ positions on cap-setting

The cap is, as mentioned above, set at the national level and varies according to the burden sharing agreement between the Member States. According to Christiansen and Wettstad, “the lack of specific targets owes largely to the understanding that the early inclusion of such targets would probably invoke controversies among Member States and delays in the political negotiations” (2003: 10). The Working Group on the Review of the EU ETS was to explore a single EU-wide cap versus caps determined by the Member states (national caps) and whether national caps should be decided up-front in the Directive or set through national allocation plans.

Figure 2 shows key stakeholder positions on cap-setting. The data is collected from the EU ETS review position papers submitted in June/July 2007 (DG Environment 2007).

Figure 2. Interest groups’ positions on cap-setting

Interest group	Type	Position
EURELECTRIC	Electricity producers	EU-wide, top-down approach Equitable burden-sharing between trading and non-trading sectors
COGEN	Electricity producers – combined-heat-and power	EU-wide overall cap, alternatively EU-wide sectorial caps Cap methodology should be public as early as possible
BusinessEurope	Cross-sector business association	Calls for evaluation of both central EU cap and national caps
The Key Stakeholders Alliance for ETS Review	Alliance of energy intensive industry organizations	Long-term objectives, transparency and a competitiveness-neutral cap
CEMBUREAU*	European cement industry – electricity consumers	Not absolute caps
EUROFER*	European iron and steel industry – electricity consumers	30% by 2020 and 50% CO2 reduction per ton of primary iron produced beyond 2020
EDF**	Company – energy producer	An absolute EU-cap, leading to sectoral sub caps
E.ON**	Company – energy producer	Central EU cap
CAN Europe	Environmental organisation	30% by 2020. EU-level.
WWF	Environmental organisation (CAN Europe member)	30% by 2020. EU level. Total number of permits to be released into a trading period decided by the Commission

* Also part of The Key Stakeholders Alliance for ETS Review

** Also members of EURELECTRIC

The electricity producers advocate an EU top-down approach. Caps should be set at the EU level – rather than at the national level. Moreover, the producers emphasize the importance of

equitable burden-sharing between trading and non-trading sectors: “The electricity industry should not be unduly disadvantaged vis-à-vis other sectors as all economic sectors must engage in reducing greenhouse gas emissions if EU targets are to be achieved” (EURELECTRIC 2007: 6). This implies that the same cap should apply for the sectors covered by the EU ETS as the non-trading sector.

The electricity consumers – represented by the alliance of energy intensive industries – emphasises the need for long-term objectives, transparency and a competitiveness-neutral cap. European iron and steel producers (EUROFER) suggest 30 percent CO₂ reduction per ton of primary iron produced by 2020 and 50 percent beyond 2020, and hence advocates a carbon intensity cap for the iron and steel sector. The cement industry (CEMBUREAU) also rejects absolute caps. EUROFER argues that a cap based on a base year (historical emissions) does not take into account the current or future market conditions. Moreover, allocations are made independent of efficiency and past efforts to reduce greenhouse gas emissions. The environmental organisations advocate an EU-wide cap, but they also emphasise the emissions reductions level, advocating 30 percent reduction compared to 1990 by 2020.

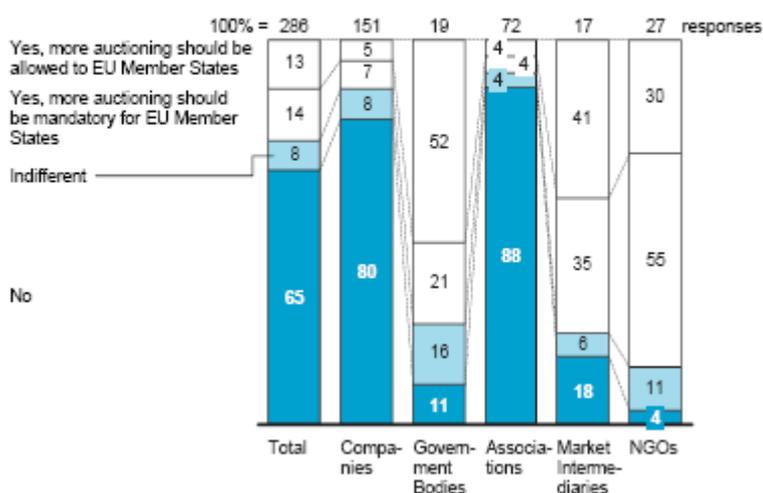
5 Stakeholders’ positions on allocation method

With regard to allocation methodology (allocation of allowances to sectors and installations), the Working Group was to explore the share of the allowances to be auctioned. If an EU-wide cap is applied, full auctioning was mentioned as an option by the Commission. Many stakeholders did prefer an EU-wide cap, and hence full auctioning was an option to be discussed.

Among the topics reviewed by the web survey ordered by the DG Environment was stakeholders’ attitudes towards auctioning. Figure 3 and 4 show, respectively, all stakeholders’ attitudes and companies’ attitudes toward auctioning.

Figure 3. Stakeholders’ attitude toward auctioning

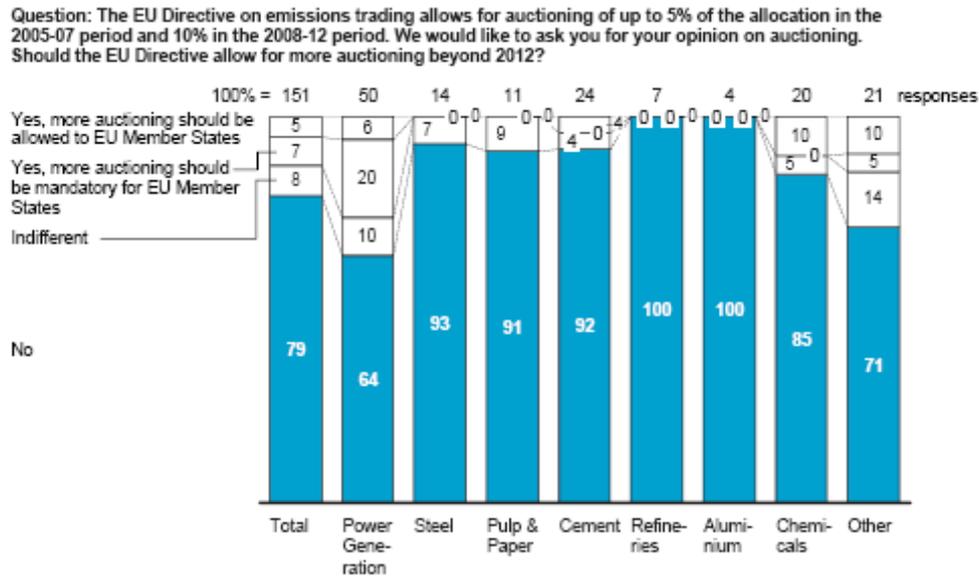
Question: The EU Directive on emissions trading allows for auctioning of up to 5% of the allocation in the 2005-07 period and 10% in the 2008-12 period. We would like to ask you for your opinion on auctioning. Should the EU Directive allow for more auctioning beyond 2012?



Source: DG Environment 2006. Survey EU ETS Review.

Figure 3 shows that companies and associations in general are negative to auctioning. Government bodies, market intermediaries and non-governmental organisations (NGOs) are positive to auctioning. More than half of the group of NGOs prefer mandatory auctioning.

Figure 4. Companies' attitudes towards auctioning



Source: DG Environment 2006. Survey EU ETS Review.

Figure 4 shows the attitude of companies to auctioning. Most companies are negative, but there is a notable exception: approximately 25 percent of the power generation companies are positive to auctioning – 20 percent of the power generation companies even prefer mandatory auctioning. Companies in the energy-intensive sectors (steel, pulp and paper, cement, aluminum and chemical) do not wish to allow for more auctioning after 2012.

Figure 5 shows key stakeholders' positions on auctioning. The data is collected from the EU ETS review position papers submitted in June/July 2007 (DG Environment 2007).

While electricity producers are split in their views on auctioning, electricity consumers share the same position against auctioning. Environmental organisations support auctioning of 100 percent of the allowances. Key stakeholders' positions on allocation method will be further explored in the two sections below.

Figure 5. Interest groups' positions on allocation/auctioning

Interest group	Type	Position
EURELECTRIC	Electricity producers	Different views among their members on the method of allocation. If auction, on EU level. Benchmarking.
COGEN	Electricity producers – combined-heat-and-power	Benchmarking Not auctioning before there is a “international trading scheme with global burden sharing”
Euroheat	Small electricity producers; combined-heat-and-power and district-heating producers	Benchmarking. Auctioning – only if all actors, in both the electricity and heat markets, share a similar internalization of CO2 costs.
BusinessEurope	Cross-sector business association	Free allocation until an international agreement is reached. ‘Firmly rejects’ making auctioning the standard allocation tool
The Key Stakeholders Alliance for ETS Review	Alliance of energy intensive industry organisations	Rejects auctioning for energy-intensive industries. Performance-based allocation (PBA) through benchmarks or a baseline and credit system
CEFIC*	European chemical industry – energy consumers	PBA Auctioning only if world wide
CEMBUREAU*	European cement industry – energy consumers	Until a new system (global, benchmark or sectorial) is implemented; no auctioning – free allowances to the cement industry
EUROFER*	European iron and steel industry – energy consumers	Baseline and Credits approach
EDF**	Company – energy producer	Partly through auction. Presents three types of allocation rules to be mixed.
E.ON**	Company – energy producer	Stepwise move toward full auctioning. Additional climate change policy instruments should be removed for EU ETS participants.
CAN Europe	Environmental organization	100% auction
WWF	Environmental organization (CAN Europe member)	100% auction

* Also part of The Key Stakeholders Alliance for ETS Review

** Also members of EURELECTRIC

5.1 Electricity producers' positions on allocation method

Markussen and Svendsen (2005:249) divide the electricity sector into large producers, nuclear utilities, small combined heat and power (CHP) and district heating (DH), biomass, and wind. The electricity producers do not have a common position of allocation method.

The large producers typically produce electricity from several technologies – both fossils, nuclear and renewables. EURELECTRIC organizes large electricity producers, which have a wide range of interests depending on their dependency on fossil fuels. While the German energy company E.ON has large CO2 emissions per TWh, the French company EDF mainly produces electricity from nuclear and hydro – with no CO2 emissions. According to

EURELECTRIC's position paper, there are "different views within the electricity industry on the method of allocation to use after 2012. Regardless of the method chosen, there will be distributional effects." EURELECTRIC emphasises the importance of harmonized allocation methods and predictability.

EURELECTRIC does not have a common position on whether more allowances should be auctioned post-2012. However, it has several suggestions on how auctioning should be applied: "Auctioning should not be limited to the electricity sector, but include all the trading sectors which internalise the costs of allowances in their product price. Other sectors need to provide a robust justification on competitive grounds why they should not be subject to the same level of auctioning as the electricity sector." This is in line with their position on cap-setting, where they emphasize equality between the trading and non-trading sectors with regard to burden-sharing.

Several members of EURELECTRIC have submitted their own position papers: EDF, EOn and Scottish and Southern Energy Group (the latter is not public). EDF presents three types of allocation rules to be mixed, while EOn considers the EU ETS.

Euroheat & Power represents public and municipal owned CHP and DH (Markussen and Svendsen 2005:250). Euroheat & Power calls for a harmonised benchmark system for electricity and heat with two benchmarks (a double benchmark) as a starting point: one benchmark for heat, one for electricity. The long-term aim is an allocation system with only one benchmark. Euroheat & Power also underscores the importance of predictability. Auctioning is only considered to be acceptable if all actors, in both the electricity and heat markets, share a similar internalization of CO₂ costs. COGEN, which represents industrial CHP and CHP technology producers (Markussen and Svendsen 2005:250), also advocates a double benchmark system, and rejects auctioning before there is an "international trading scheme with global burden sharing" in place.

The European Wind Energy Association (EWEA) attended the EU ETS review process, and also submitted a position paper, but the position paper of EWEA was one of four papers not made public. However, EWEA responded positively to the energy and climate package, and states that "EWEA welcomes the Commission's decision to establish full auctioning for the power sector from the start of the new regime in 2013" (EWEA 2008).

5.2 Electricity consumers' positions on allocation method

The European energy-intensive industries have submitted a joint position through 'The Key Stakeholders Alliance for ETS Review' (the Alliance). The Alliance consists of ten European associations representing the European Cement Association (CEMBUREAU), the Confederation of European Paper Industries (CEPI), the Liaison Office of the European Ceramic Industry (CERAME-UNIE), the Standing Committee of the European Glass Industries (CPIV), the European Lime Association (EULA), the federation of European chlor-alkali producers (EUROCHLOR), the European Confederation of Iron and Steel Industries (EUROFER), the European non-ferrous metals industry (EUROMETAUX), the International Federation of Industrial Energy Consumers (IFIIEC), and finally, the European Chemical Industry Council (CEFIC) -which is not covered by the EU ETS today.

Energy-intensive industries reject auctioning as an allocation method within the EU ETS. Auctioning is only considered to be an option if a global emissions trading system – one that includes both developed and developing countries – is established. The Alliance argues that auctioning is unpredictable, and that the costs for companies competing with non EU countries would put EU industries at a competitive disadvantage without significantly improving the environment. The Alliance suggests that a so-called performance-based allocation (PBA), through benchmarks or through a baseline and credit system, should be an option for large emitting, homogeneous processes, while other more dispersed activities may

remain with an allocation based on grandfathering. The Alliance believes PBA will lead to a level playing field.

The position of the energy-intensive industry is coherent and advocated not only through the Alliance, but also through the associations. In addition to the position paper submitted by the Alliance, three members of the Alliance have submitted position papers on behalf of their own organisation advocating Performance-based allocation (PBA): CEFIC, CEMBUREAU and EUROFER. CEFIC calls for PBA – and can only accept auctioning if it is in a truly global emissions trading regime. EUROFER recommends PBA, through a Baseline and Credits approach. The baseline is the weighted average of emissions per tonne of production for the sector. Allowances are allocated according to baseline. Any plant performing worse than the baseline must pay for allocations traded from plants performing better than the baseline. CEMBUREAU rejects auctioning until a new system (a global emissions trading scheme, a benchmark, or sectorial system) is implemented. Until such a system is in place, CEMBUREAU calls for free allowances to the cement industry.

BusinessEurope (former UNICE) is a cross-sector business association. The association organizes big industrial companies with above-average energy and emissions intensity (Michaelowa, 1998:157). The organization has not been able to reach one common position, but advocates free allocation until “a comprehensive international agreement involving all major emitting countries undertaking comparable efforts is established” and “firmly rejects” making auctioning the standard allocation tool of the EU ETS. BusinessEurope calls for a careful assessment of the PBA and (sector-specific) benchmarks in a cap-and-trade-system, but does not support any of these specific allocation methods. “For some sectors [PBA and benchmarks] could be a good option whilst for others an inappropriate allocation methodology.”

6 The Commission’s proposal

The legislative proposal was presented as part of the Commission’s ‘Climate action and renewable energy package’ on 23 January 2008. The Commission proposes to substitute national cap-setting by a single EU-wide cap in the trading sector. The cap is set at 21 percent below 2005 levels. An EU-wide cap is supposed to guarantee that the emission reduction objectives will be met.

To reach the aim of 20 percent reduction by 2020, the emissions of the EU have to be reduced by 14 percent compared to 2005. The Commission proposes cutting emissions by 21 percent in the trading sector and 10 percent in the non-trading sector. While the cap applying to the trading sector is EU-wide, the 10 percent reduction in the non-trading sector will be differentiated. The reduction efforts take into account the relative per capita GDP of the Member States. Member States having a relatively high GDP per capita should reduce their greenhouse gas emissions compared to 2005; Member States having a relatively low GDP per capita will be allowed to increase their greenhouse gas emissions.⁵

The choice of an EU-wide cap is in line with EURELECTRIC’s position. However, the cap in the trading sector is set at 21 percent by 2020, compared to 10 percent by 2020 in the non-trading sector, and this is not in line with the position of EURELECTRIC. The electricity producers’ organization had emphasized the importance of an equitable burden sharing between the trading and non-trading sectors. This view has not been taken into account in the Commission’s proposal.

⁵ The Commission proposes allowing the new Member States and Portugal to increase their greenhouse gas emissions; the EU-15 (except Portugal) and Cyprus have to reduce their greenhouse gas emissions.

The electricity producers were not able to act jointly by advocating one clear and common position. Even though EURELECTRIC and COGEN/Euroheat & Power participated in the EU ETS review process, they were outnumbered by the electricity consumers.

The electricity consumers have not emphasised cap-setting – which applies to all sectors – but rather the allocation method. The Commission’s proposal states that auctioning should be the basic principle for allocation as allocation ‘is the simplest and generally considered to be the most economically efficient system’ (European Commission 2008: 14). Auction will also eliminate windfall profits. Although auctioning should be the basic principle for allocation, this principle will only apply to power generation (electricity producers) and carbon capture and storage from 2013. Other sectors will have a gradual transition from 20 percent auctioning in 2013 to 100 percent in 2020.

However, energy-intensive industries might get an exemption if a post-2012 international agreement based on the objective of limiting global temperature increase to 2 degrees Celsius is not reached: “In the event that other developed countries and other major emitters of greenhouse gases do not participate in this international agreement, this could lead to an increase in greenhouse gas emissions in third countries where industry would not be subject to comparable carbon constraints (‘carbon leakage’) and at the same time could put certain energy-intensive sectors and sub-sectors in the Community which are subject to international competition at an economic disadvantage.” (European Commission 2008: 16).

Sectors and sub-sectors threatened by carbon leakage might get up to 100 percent of the allowances for free; alternatively, a carbon equalization system could be introduced. The aim of such a system will be to put “installations from the Community which are at significant risk of carbon leakage and those from third countries on a comparable footing” (European Commission 2008: 17). An assessment of which sectors or sub-sectors this exemption will apply to will be made in 2010-2011.

The Alliance of energy intensive industries was well-represented in the four meetings arranged by the Working Group on EU ETS under the ECCP. The Alliance also submitted one joint position paper/letter in June/July 2007 in addition to three position papers from CEFIC, CEMBUREAU, and EUROFER. The energy-intensive industries would have preferred to get an unconditional exemption, but the outcome can nevertheless still be considered successful, as no other sectors were given an opportunity to get free allowances.

7 Conclusion

The Commission’s proposal is not in line with the positions of the electricity producers. The electricity sector is the only sector – together with carbon capture and storage – where the principle of auctioning is applied from 2013. Nor did the electricity-producing sector succeed in getting an equal burden-sharing between the trading and non-trading sectors. While the sectors covered by the EU ETS face a 21 percent reduction by 2020, the non-trading sector faces a 10 percent reduction.

The Alliance of energy-intensive industries was far more successful. Even though these industries did not get an exemption from the scheme, the Commission’s proposal includes an opportunity for an exemption for energy-intensive sectors subject to possible carbon-leakage. The proposal opens for free quotas, alternatively a carbon equalisation system.

There were many strong but coherent voices from the energy-intensive industries in the EU ETS review process. Even though they did not fully succeed, their interests were definitively taken into account.

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