

# Allowance Allocation in the EU ETS: Past, Present, and Future



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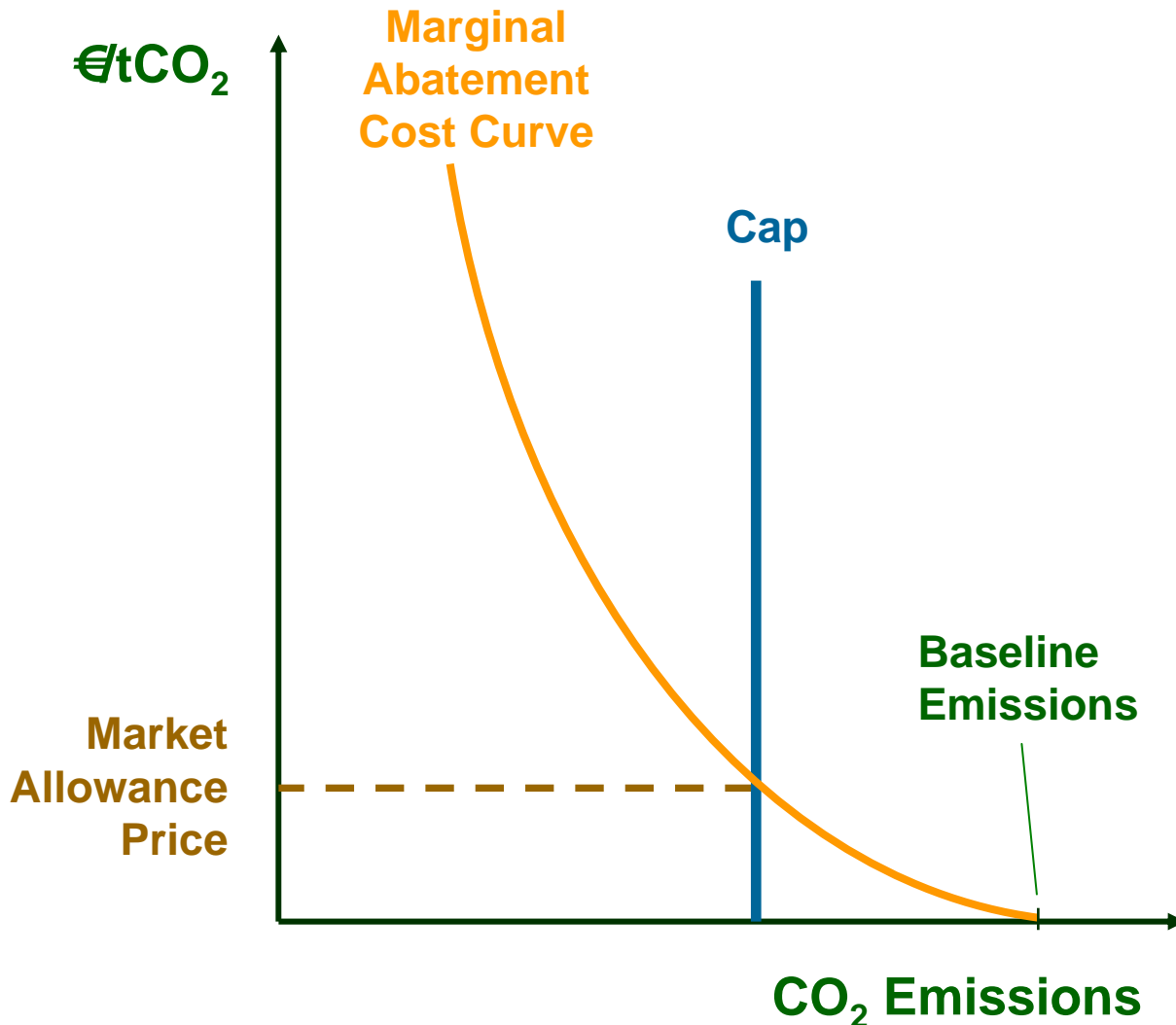
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- **Emissions trading—the theoretical ideal**
- **The aims of allocation**
- **Options for allowance allocation**
- **EU ETS: Phases I and II**
- **EU ETS: Phase III**
- **Implications for compliance and trading**

# Allocation vs. Cap-Setting



- Cap determines allowance price
- Level of free allocation **does not** affect allowance price
- Market price determines how much participants should emit, and how much they should abate
- Allowance price sets **variable cost** of emitting
- Allocation provides a subsidy to **fixed costs**
- Allocation only affects company behaviour under certain circumstances

# What is allocation For?



## ■ “Traditional” aims

- To offset “*stranded costs*” due to change in regulation
- To achieve policy acceptance

## ■ Other aims

- Avoiding competitive distortions (incumbent vs. new entrant)
- Avoiding competitive distortions (domestic vs. foreign)
- Avoiding emissions “*leakage*”
- Reward “*early action*”
- Maintain energy security
- Promote specific (clean) technologies
- Improve efficiency of tax system (via allowance auction)

# Types of allocation



- **Emissions-based vs. benchmarked**
    - Allocation is generally done by computing an allocation “*metric*” that determines the share of the overall allocation pie
    - High-emitting plants do better under emissions-based approaches
    - Benchmarks can be based on capacity, output, input efficiency, etc.
  - **Historical vs. updated**
    - Choice between these is independent of choice of metric
    - The two can differ significantly in their incentive effects
  - **Auctioning**
    - Significant question: what will governments do with auction revenues?
- Historical emissions-based approaches are often referred to as “*grandfathering*”
  - Advocates of “benchmarking” are often really in favour of *updated* benchmarking

# Other allocation design issues



- **Baseline period**
- **Allocations to New Entrants**
  - A special form of updating
- **Confiscation of allowances from closed sites**
  - Another special form of updating
- **Differentiation by sector**
  - Including the use of sector-specific growth rates, benchmarks, etc.
- **Ex-post adjustment**
- **Credit entitlements (CERs / ERUs)**

# EU ETS so far



	Phase I	Phase II
<b>Cap-setting</b>	Via Member State (“MS”) NAP; some Commission oversight	Via MS NAP; more harmonised (and stringent) oversight
<b>Auction levels</b>	5% maximum; less than 1% used	10% maximum; less than 5% used
<b>Allocation methodology</b>	Mostly historical emissions, some benchmarking	Mostly historical emissions; more benchmarking
<b>Sector differentiation</b>	Many MSs used sector-specific growth projections and other factors	
<b>Installation allocation</b>	By MS	
<b>Banking</b>	No	Yes
<b>New entrants / closure</b>	New entrant allocation provided in most MSs; closures forfeit rights	
<b>Ex-post adjustment</b>	Rejected by Commission; permitted by European Court of First Instance	Rejected by Commission; legal challenges may go forward

# Commission Phase III Proposal

(published 23 January 2008)



- Centralise and **harmonise** cap-setting *and* allocation
  - Commission to propose implementation measures (**benchmarks**) by 2011
- Much greater use of **auctioning**:
  - 100% for electricity generators, 20% → 100% for other sectors
- Sectors facing international **competition** and **leakage** may receive higher allocation
  - Must **demonstrate** higher costs, lower profits, lost sales and leakage
  - Depends on an economic analysis of markets and competition
- Limits on use of international project **credits**
- Unrestricted **banking** between Phases II and III
- Allocations and caps may be reduced with **global agreement**

# How allocation affects emissions and trading strategies



- In theory, assuming idealised implementation, it doesn't... BUT it **can**:
- If your Phase III allocation depends on what you do in Phase II
  - Increase capacity, output, or even emissions for relevant base years
- If there are limits on the number of credits (CERs) you can use, and the market is not efficient in matching potential buyers and sellers
  - Ability to use credits can be bought / sold alongside allowances
- “A bird in the hand is worth two in the bush”:
  - Companies may delay selling surplus allowances in Phase II in case they need them later
  - Companies may wish to bank current allowances, rather than rely on uncertain future secondary market or future allocations

# Further reading



- **NERA report for International Emissions Trading Association (IETA) on allowance allocation:**

[www.ieta.org/ieta/www/pages/getfile.php?docID=2543](http://www.ieta.org/ieta/www/pages/getfile.php?docID=2543)

- **Forthcoming NERA report for European Commission on allowance allocation:**

[ec.europa.eu/environment/climat/emission/ets\\_post2012\\_en.htm](http://ec.europa.eu/environment/climat/emission/ets_post2012_en.htm)

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