



IPA Energy Consulting

UK National Allocation Plan (NAP) is Published - Not Quite “Business As Usual”

The UK National Allocation Plan (NAP)

The publication of the UK draft National Allocation Plan (NAP) for the forthcoming EU emissions trading scheme has significant implications for all the sectors covered by the scheme. This plan sets out how the allowances will be distributed in the first phase of the scheme (from 2005). While the UK is in the fortunate position of being relatively close to its emissions targets (at least for the first phase) and hence has relatively generous allocations, on average installations will face around a 10% shortfall in permits required for the business as usual case. In individual cases the situation will be much worse because allocations have been based on historic emissions without any consideration of the effects of changes in sites’ activities – a long outage or low demand in the years in question could make a huge difference to your allocation and hence the cost of doing business for the next three years. Affected installations have until the 12th March to comment on the draft before it is submitted to Brussels.

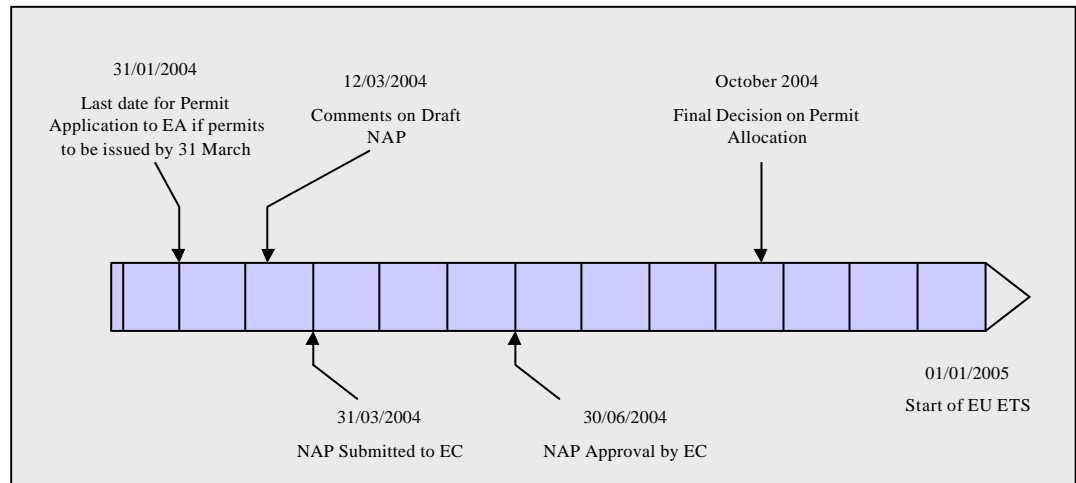
IPA can help you understand the implications of the proposals for your business – call Francisco Ascuí or Peter Bedson on 0131 240 0840 for further information.

The NAP Timeline

Publication of the UK’s National Allocation Plan (NAP) on 7th January 2004 marked the latest stage of the process to implement the EU Emissions Trading Scheme (EU ETS) (See Figure 1 below). The NAP sets out how allocations of “permits to pollute” under the ETS will be distributed between the 1500 or so installations covered by the trading scheme in the UK for the first phase of trading (2005-2008). The UK is the first of the 25 EU and accession countries covered by the scheme to publish its draft NAP and many of the other countries are lagging so far behind that any form of public consultation on their NAP is highly unlikely (see article elsewhere in this newsletter).

A few inspired leaks in the run up to publication day for the UK’s NAP softened up opinion and – aside from some ritualistic hand-wringing from the CBI in general and energy-intensive industries in particular - the NAP seems to have been seen as broadly acceptable. The headline story is that all the industries covered by the ETS will receive their “projected” requirements – less an allowance for “new entrants” - except for the power generation sector where all the “extra” emissions savings are to be found. This may, however, not tell the whole story.

Figure 1: Implementation of the EU Emissions Trading Scheme



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Clarity of NAP

The Draft NAP itself is not the easiest of reads and, as usual, much of the devil is buried in the detail. The most significant issue is that all the numbers in the plan are – to a greater or lesser extent - provisional and subject to revision when better data becomes available. This means that allocations may change substantially as more data is pulled together or verification is completed. Indeed things are likely to continue to change right up to the point that the allowances are issued. The entire allocation process in the plan is based on the projections carried out by DTI updating those in Energy Paper 68. These so-called UEP projections form the backbone of the NAP and are worthy of some scrutiny. Firstly, the UEP makes some fairly aggressive assumptions regarding the savings achieved by all the climate change policy measures outside the EU ETS. These assumptions effectively lock in the projected benefit of the Renewables Obligation, the Climate Change Levy and other policy measures in setting the headline level of emissions under the business as usual case. Secondly, it is clear that some of the projections are at some variance to industry's own views of its emissions.

“Two Stage Process”

The allocation process is in effect a “two stage process”. This means that the “business as usual” case is split to allocate projected emissions between the “traded” (i.e. covered by the EU ETS) and “non-traded” sectors. The traded sector is then further split, again based on the projected emissions from the sectors, to give a total allowance for each industry or sector. This allowance is then reduced to set aside a “pot” of allowances for new entrants (see below) and the remainder divided up between installations based on historic emissions data.

The only exception to this general pattern is for the electricity generating sector – here the industry's pot of allowances will be further reduced by the 2005—2007 proportion of the 5.5 million tonnes of carbon dioxide needed to meet the government's target in 2010. The generation sector is singled out on the grounds that it has relatively little international competition and access to relatively low cost carbon abatement opportunities. Overall, the reduction in the NAP represents a 5.8% reduction in total emissions from business as usual and is consistent with achieving a 16.3% reduction in 2010 as against the Government's target of 20% (see Figure 2). Therefore a significant further tightening of targets is likely in the second phase of the scheme - which runs from 2008-2012 – if the Government's 20% target is to be met.

Pot of Allowances

Historic emissions – excluding the worst year – from the period 1998-2002 (where sufficient data is available) has been selected as the basis for splitting up each sector's share of the overall “pot”. This is intended to give some credit for early action but implies a significant shift in value within the

sectors. There is considerable disquiet in certain industries that this fails to give proper credit for “early action” such as the recent adoption of CHP. The Government has indicated that it will look at specific issues as a result of the consultation but it seems likely that the final allocation methodology will have to be general in its application and so not capable of “negotiation” on a plant level.

The draft NAP is accompanied by a snapshot view of allocations to the various participants based on the current data. This is clearly partial (only around 900 of the expected 1500 sites are covered) and therefore for no other reason than this, it is likely that individual allocations will reduce as more and more sites are discovered and added to the calculation. Some of the allocations published to date appear on first inspection to be bizarre, with similar power stations with similar historic load factors receiving allowances that differ by 50%. This may reflect in part the poor quality of data upon which some of these allocations are based – part of the next phase of the process will verify the data included in the allocation methodology.

The Story So Far

The Government held a seminar at a snowy National Exhibition Centre (NEC) in Birmingham on 28th January to explain the story so far, and the next steps are a series of sector meetings over the next month at which specific issues will be debated. There is clearly going to be considerable special pleading from many of the sectors and players who see themselves as special cases. The danger of this for others is that the allocation methodology may be adjusted to favour these participants, thereby reducing the quantities available for others. Final allocations are, on balance, likely to be lower than their provisional numbers, as special cases are dealt with and unknown installations creep out of the woodwork. Participants would probably do well at this stage to get their special pleading in early – it may help minimise the reduction that they will see between now and the actual allocation late this year.

Closure and New Entry

The most striking feature of the plan is the treatment of closure and new entry. Here the Government is seeking to steer a course that maintains the incentive to continue to invest in the UK while preserving security of supply and a level competitive playing field between incumbents and new entrants. The Government has decided that new entrants will receive free allocations from a special New Entrant Reserve (“NER”) and that installations that close will surrender permits allocated but not yet issued. As permits will be issued annually, in effect this means a plant closing in 2005 would retain its permits for that year but would not receive any permits in subsequent years, with the surrendered permits returned to the NER. Plants opening within a year will receive a *pro-rata* distribution of free issue permits from the NER – probably against some benchmark standard for the technology – for that year and then full allowances for each future complete year.

Clearly, the allocation of permits has significant value to existing plants – Drax’s allocation alone is worth around €600 million at current market prices – and many plants would be worth more “dead than alive” if they were allowed to retain the permit allocation. This measure removes the incentive to close early and monetize the permits but creates an incentive to keep “open” while minimising costs – perhaps by closing capacity on the site. The interplay of the two measures also

removes the incentive to close one day and reopen the next – receiving a further free allocation of permits as a “new entrant” on the way. One of the major topic of consultation over the next two months will be the definition of “closure” but indications from DEFRA are that there will be no “partial closure” so a four unit power plant could, potentially, decommission three of its units and retain all the permits allocated in the phase.

Figure 2—National Allocation Plan (NAP)

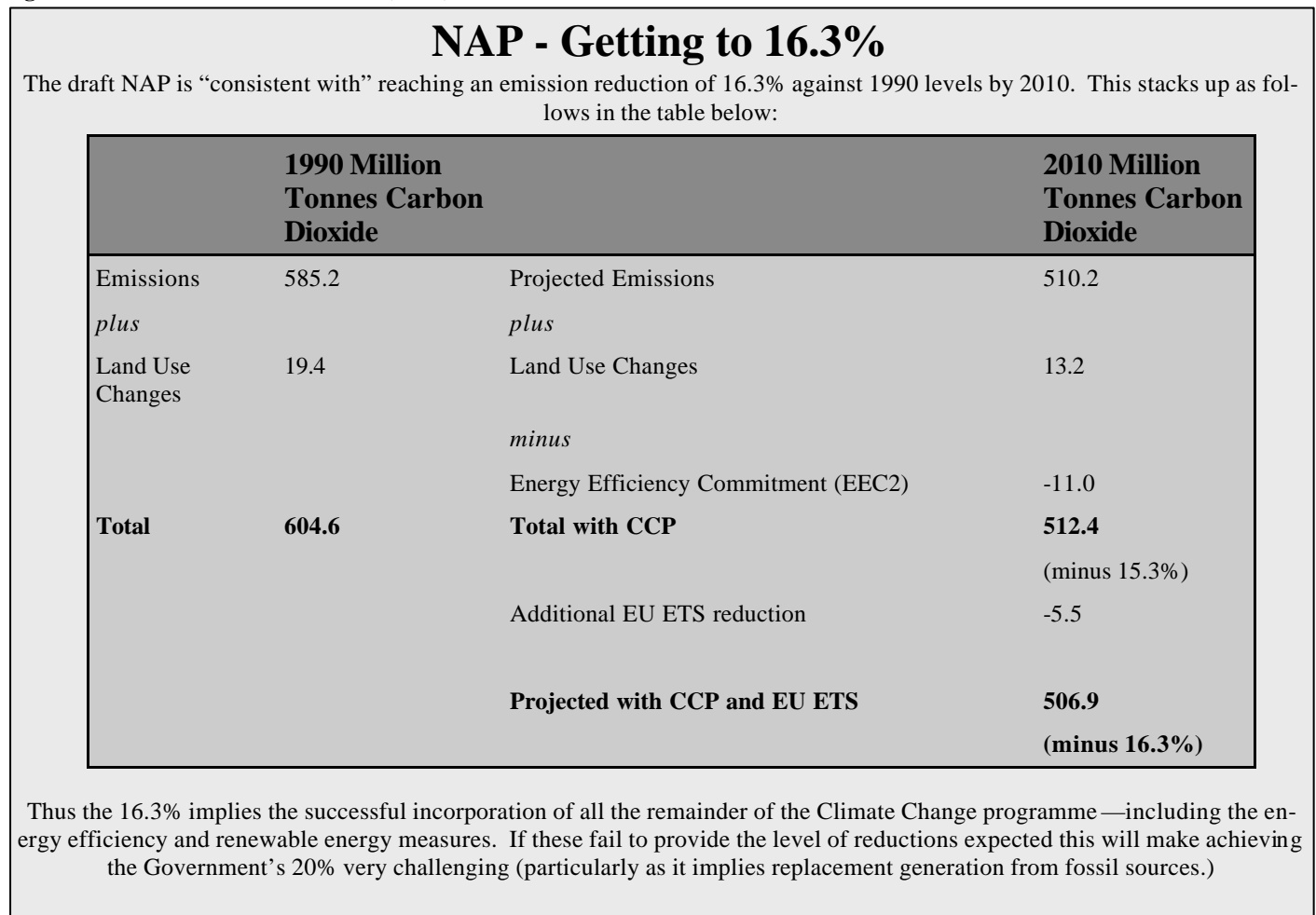
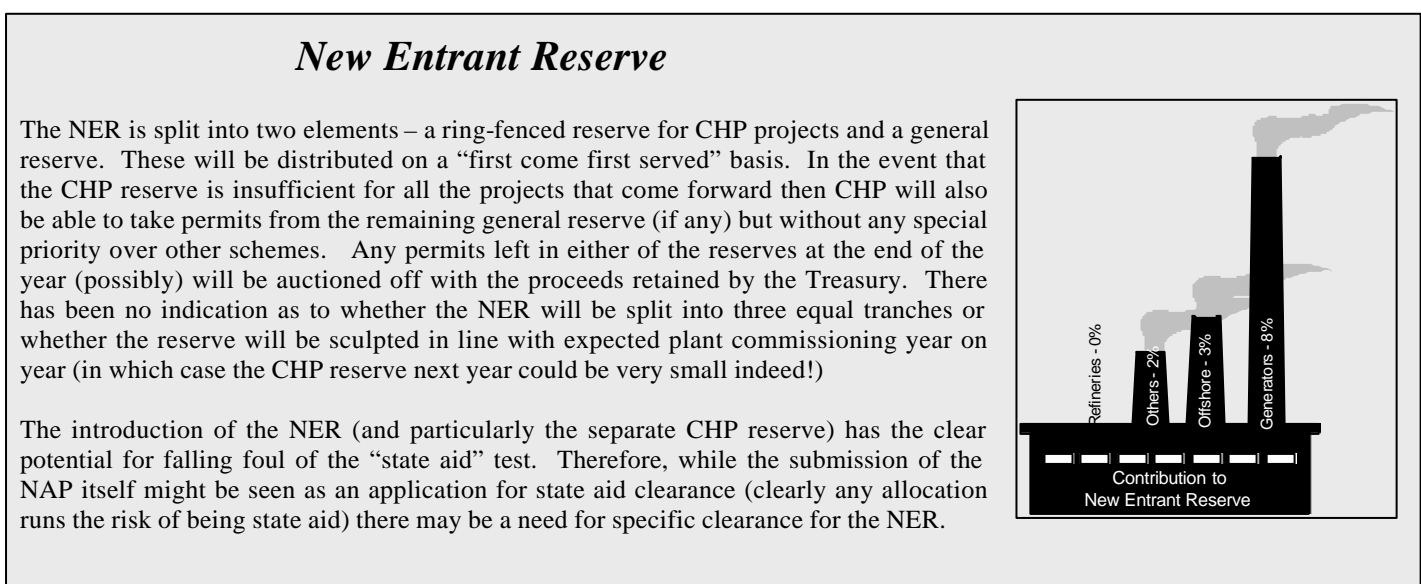


Figure 3—New Entrant Reserve (NER)



Banking

One of the major restrictions announced in the draft NAP is the ruling-out of banking of allowances between the first two phases. Banking between subsequent phases is guaranteed under the terms of the Directive but the first two phases introduce problems because of the overlap with the Kyoto commitment periods. This means that – in theory at least – banked allowances from the first phase could cause the UK to violate its Kyoto commitments in the second.

There had been some expectation that limited banking between phases would be allowed (as if one state allows banking, trading could be used by all the others to achieve banking regardless of an individual state's decision). However, the Government has indicated that most states are expected to rule out banking between the first two phases.

Opt-Out

While many sectors might *wish* that they could opt out of the scheme; there are two groups that may have the opportunity – those trading within the UK's own pilot emissions trading scheme and those with Climate Change Agreements (CCA). CCA's allow participants to avoid part of the climate change levy applied to industrial sales of electricity, in exchange for binding commitments to reduce emissions. Both groups have the option to seek to opt out of the scheme subject to meeting three criteria:

- Environmental “equivalence”;
- Monitoring, reporting, and verification requirements equivalent to those within the scheme; and
- Penalties for non-compliance at least as stringent as the schemes.

The acceptability of the opt-out is to be judged by the Commission (on the basis of qualified majority voting) and is not guaranteed. It is clear that there will have to be changes to both the Climate Change Agreements (most notably to translate relative targets – emissions per unit of output – to absolute targets comparable with the ETS) and to the UK pilot trading scheme (UK ETS). These changes will remove indirect emissions (emissions indirectly produced from the generation of electricity used on sites covered by the CCAs) and exclude other greenhouse gasses and sectors that are not currently covered by the EU ETS. The Government is currently working to finalise these changes and the allocation methodologies to ensure that when industry has to make a decision on exercising the opt-out they understand both the changes to their agreements and the allocations they will receive in the ETS if they do not opt-out.

IPA's Predictions

We predicted in July that the NAP would be based on a direct emissions metric, with the overall cap and sectoral targets based on regulatory targets (i.e. the 20% target by 2010) and installation level allocations based on a combination of historical emissions and benchmarking. This is pretty much how the draft NAP looks today.

On the carbon price, current price markers range from €13-14 for the first commitment period. However, these views of the market have been based on very few trades. We expect there to be a downward correction in the market shortly as participants take account of unexpectedly generous allocations in countries such as the Netherlands and Germany, together with likely amendments to the EU Linking Directive. For more information on IPA's price forecasting and modelling the impact of price projections at plant level, contact Peter Bedson or Michael Wagner on 0131 240 0840.

IPA Energy Consulting—The Company



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IPA Energy Consulting designs, implements and supports regulatory frameworks and markets in the electricity and gas sectors. IPA has been working at the leading edge of electricity de-regulation and market development for 14 years and is now one of the leading practices in Europe in this specialised area. The Company has global experience in creating, implementing and strengthening energy markets, both electricity and gas, in order to increase competition, raise economic efficiency, attract private sector capital, foster renewables and promote emissions reduction, and is now moving into other fields, including water. The firm is multi-disciplinary, with more than 40 full-time staff with expertise in economics, finance, regulation, law as well as power and gas engineering. IPA is headquartered in Edinburgh.

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