Revision of the EU ETS Directive in the context of the EU's 2030 package: what has the European Commission proposed?

On 15 July, the European Commission published a legislative proposal to revise the EU ETS to reflect the 'ETS elements' of the EU's 2030 climate and energy framework. It translates into legislation the political intentions set out by the October 2014 Council Conclusions, aimed at strengthening the system and ensuring its correct functioning in the post-2020 period. This briefing outlines the main changes proposed by the European Commission.

Background to the ETS revision

On July 15 2015 the European Commission (EC) published a legislative proposal to revise the EU ETS Directive for the period post-2020. Following an 'emergency measure' to fix the EU ETS (the so-called backloading proposal, finalised at the end of 2013) and after the adoption of the Market Stability Reserve (MSR), this legislative proposal represents the last piece of the puzzle to revise the ETS and ensure its well-functioning in the post-2020 period.

The ETS revision translates into a legal proposal the political agreement that was reached by European Heads of States on the EU's 2030 climate and energy framework in October 2014 (here). The document puts forward several amendments to the ETS Directive. Below we detail the most relevant changes.

ETS Cap

- The **linear reduction factor,** i.e. the percentage by which the ETS cap declines each year, will be increased from 1.74% to **2.2%** a year. This is in line with a 40% GHG emissions reduction for the EU as a whole by 2030 compared to 1990 levels, entailing a **43% reduction for ETS sectors by 2030** compared to 2005 levels.
- This corresponds to an additional reduction of around 556 million tonnes between 2021-30.

Phase IV of the EU ETS

- Phase IV of the EU ETS has been extended to last 10 years compared to the 8 years of Phase III, and will run from 2021 to 2030.

Share of Auctioned Allowances vs. Free Allowances

- From 2021 onwards the **share of allowances to be auctioned** by Member States, including allowances targeted for the modernisation fund **shall be 57%**. This constitutes a different approach to the existing way of determining the maximum amount of allowances available for free allocation, which is the result of a calculation rather than a percentage of total EU allowances.
- The remaining 43% will be used for free allocation for sectors at risk of carbon leakage and for the Innovation Fund.

Cross Sectoral Correction Factor

- The sum of **free allowances is limited**. If it exceeds the maximum level, free allocation shall be adjusted accordingly. This *de facto* implies that the **application of the Cross Sectoral Correction Factor** (CSCF), if needed, will continue in Phase 4.
- If the maximum level is not reached, the remaining allowances shall be used to prevent/limit the application of the CSCF in later years. This introduces greater flexibility in the annual allocation to limit the impact of the CSCF in case not all free allowances are allocated.

New Entrants Reserve

- Allowances that were meant to be distributed for free to sectors not considered to be at risk of carbon leakage but that were not allocated by 2020 (estimated to be approximately 145 million) **together with 250 million allowances** placed in the MSR, shall be **set aside for new entrants** and significant production increases.
- From 2021, allowances not allocated to installations due to closures or partial cessation of operations shall be added to the new entrants reserve instead of being auctioned.
- In total around **400 million allowances will be made available until 2030 for new entrants**.
- Allowances from the new entrants reserve will also be made available for significant production increases by applying the same thresholds and allocation adjustments that apply to partial cessations of operation. The exact thresholds are not yet specified.

Activity Levels

- In the period 2021-2025, allocation will be determined based on updated activity levels from the years 2013-2017. A second update of activity levels will apply as of 2026.
- These activity levels will be submitted by Member States as part of their National Implementation Measure (NIM) exercise. A list of installations covered by the ETS Directive shall be submitted by 30 September 2018 for the 5 years beginning on 1 January 2021. These lists will include information on

production activity, transfer of heat and gases, electricity production and emissions at sub-installation level and shall be submitted every 5 years.

- Free allocation will only be given to installations where such information is provided; thereby adding an additional criteria for installations to be eligible to receive free allowances.

Benchmarks

- Benchmark values will be updated to avoid windfall profits and reflect technological progress. **Benchmark values shall be reduced compared to** the value that was set for Phase III based on 2007-08 data. It will decline by 1% **each year between 2008 and the middle of the relevant period of free allocation**, unless:
    a. There is evidence that the values of a benchmark differ from the default annual reduction by more than 0,5% higher or lower. If so, that benchmark value will be adjusted by 0.5% higher or lower each year;
    b. A special derogation will be in place for the benchmark values for aromatics, hydrogen and syngas. These benchmark values will be adjusted by the same percentage as the refineries benchmark in order to preserve a level playing field for producers of these products.
- **Benchmarks will be updated twice in Phase IV of the EU ETS.** The first update will be for the benchmark values used as of **2021** and these values will be kept stable until 2025. The middle year for this first 5-year period is 2023 and therefore the benchmark value for 2021-2025 will be reduced by 15% (corresponding to a 1% decline between 2008-2023), and this reduction will apply to the Phase III benchmark value. The second update will concern the benchmark values applied as of **2026** and these values will in turn be kept stable until 2030. The middle year for this 5-year period is 2028, therefore benchmarks will be 20% lower from 2026-2030 compared to Phase III.

Carbon Leakage List

- **The new carbon leakage provisions divide sectors into two categories**:
    a. Those considered to be at **risk of carbon leakage**, which will receive **allowances free of charge at 100% of their benchmark level**;
    b. **Other sectors** considered to be at low risk or at no risk of carbon leakage because they are able to pass on a larger share of the carbon costs, **will receive allowances free of charge at 30% of their benchmark level**.
- The first category is in line with the current rules while the second one represents a change: in Phase III, sectors not on the carbon leakage list undergo a transitional system declining from 80% free allocation at the benchmark level in 2013 to 30% in 2020, with a view of reaching 0% in 2027. The new provision will fix the free allocation level for sectors not exposed to the risk of carbon leakage at 30% of the benchmark throughout Phase IV.
- **Around 50 sectors are expected to be considered at risk of carbon leakage under the new rules**.
- **The Commission proposes that allocation decisions are made for a period of 5 years instead of the current 8. This shorter period allows the use of more recent production data.**

Carbon Leakage Indicators

- Sectors & subsectors will be **deemed to be at risk of carbon leakage if the product exceeds 0.2 from multiplying**:
    a. **their intensity of trade** with third countries (calculated as the ratio between total value of exports to third countries plus the value of imports from third countries and the total market size of the European Economic Area - calculated as the annual turnover plus total import from third countries);
    b. **by their emission intensity** (measured in kg/CO2 divided by the Gross Value Added).
- Additionally, sectors & subsectors where the same product exceeds 0.18 may be included in the carbon leakage list on the basis of a qualitative assessment.
- By 31 December 2019 the EC should classify ETS sectors following the new rules for the carbon leakage list and the new indicators outlined above, based on data for the most recent 3 calendar years available.
- Free allocation to the district heating sector will no longer be excluded from the application of the CSCF post-2020.

Indirect Costs

- The text strengthens somewhat the provision for indirect cost compensation provided by Members States by changing the wording from 'may' to 'should'.
- The text now states that Member States *should* "partially" compensate sectors exposed to the risk of carbon leakage for the carbon cost passed on in electricity prices, without going as far as making it legally-binding.
- In addition, 'Financing measures to compensate for indirect costs' is now explicitly listed as one of the ways that Member States should use auctioning revenues.

Transitional Free Allocation for the Modernisation of the Energy Sector

- The text also details the **transitional free allocation to modernise installations for electricity production**.
- This measure may be **adopted by Member States which, in 2013, had a GDP per capita below 60% of the EU average**.
- The Member States that can benefit from this measure are the same ten States benefitting from the Modernisation Fund, listed in an Annex to the proposal.
- Transitional free allocation will be deducted from the pool of allowances that the Member State would have otherwise auctioned.

- By 30 June 2019, Member States intending to make use of the optional free allocation shall publish a detailed national framework setting out the competitive bidding process and selection criteria.
- This is in line with the agreement reached by Heads of States as outlined in Article 2.5 of the October 2014 Council Conclusions.

Modernisation Fund

- The newly introduced article 10d states that **2% of the total quantity of allowances** until 2030 (representing 310 million allowances) **shall be auctioned to establish a Modernisation Fund to improve energy efficiency and modernise the energy system of certain Member States**.
- The **Modernisation Fund will support investments to improve energy efficiency and modernise the energy system in Member States with a GDP per capita below 60% of the EU average in 2013**.
- The fund will be governed by an investment board and a management committee.
- An Annex to the proposal lists the 10 Member States that can benefit from the Modernisation Fund and details the distribution of allowances by Member States.

Innovation Fund

- **400 million allowances will be made available during Phase IV to support innovation in low-carbon technologies and processes**.
- These allowances will come from the 43% share of total EU allowances, from which free allowances will also come from.
- **An additional 50 million unallocated allowances from the MSR will be made available for innovation before 2021**.
- These additional 50 million allowances serve to address the gap between now and 2020, when the new innovation fund will become operational. This arrangement was proposed in the agreed MSR text.
- It is possible for projects to benefit from combined funding from the Innovation Fund and the Modernisation Fund.

Solidarity Mechanism

- 10% of total EU allowances to be auctioned will be distributed to Member States for the purposes of solidarity and growth as detailed in the Annex IIb of the legislative proposal.

Indefinite validity of ETS allowances

- Starting in Phase IV, allowances will be valid indefinitely. This means that they will no longer be bound to specific trading phases.

Flexibility Mechanism with non-ETS sectors

- The one-off flexibility between ETS and non-ETS foreseen in the European Council conclusions of October 2014 is not included in this proposal. It will be analysed in the proposal to set national reduction targets for non-ETS sectors.

Legislative Process

- As a next step, the text will now be discussed by the co-legislators, i.e. the European Parliament and the Council. Discussions in both institutions have started taking place but most positions will be developed in 2016, after the Paris COP.
- In the European Parliament, MEP Ian Duncan from the UK and the European Conservatives and Reformists group was appointed as the lead MEP, known as the "rapporteur". It is the rapporteur's responsibility to decide on the timetable for the European Parliament's work on this ETS revision, and to draft a first report. MEPs will then table amendments to the Commission's proposal and eventually, a vote will take place on the amendments and on the draft report in the Parliament's Environment and Industry Committees. The outcome of the vote will constitute the Parliament's report.
- In the Council, the technical work will be carried out by the Working Party on the Environment (WPE) while the political work will be finalised by EU ambassadors in COREPER meetings.
- After the co-legislators have developed their opinions, then trilogue negotiations will start, which could take place as early as the second half of 2016.
- As a last step, the trilogue outcome needs to be rubberstamped by the co-legislators before being adopted in legislation

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Updated 11 November 2015