IETA's preliminary reaction to the European Commission's revision of the EU ETS Directive for the post-2020 period

IETA welcomes the publication of the Commission's legislative proposal to amend the ETS Directive in line with the EU's 2030 ambition. This represents the first legislative step to transpose the politically-agreed EU climate and energy framework, and provides clarity on the trajectory post-2020 for the EU ETS. Such clarity is important to businesses that need a stable and predictable framework in which to operate. The proposal is a natural continuum to the backloading and Market Stability Reserve decisions to reinforce the functioning of the ETS.

IETA will work on reviewing the impact of this ETS Directive proposal for carbon markets over the coming weeks. This paper represents a **preliminary reaction** from IETA members to the 15 July publications.

1. Timing

- The legislative proposal to revise the ETS Directive represents an important step, ahead of the Paris international climate agreement, that confirms the EU's ambition to reduce its GHG emissions. It also confirms European policy-makers' support for a central role for the EU ETS to deliver on this ambition.
- The timing of this proposal shows Europe's constructive intention to deliver on its climate ambition, ahead of the UN negotiations to reach an international climate agreement.

2. Reinforcing the role of the EU ETS

IETA supports the ETS as the cornerstone of the EU's climate policy for the following reasons:

- It ensures the most cost-effective abatement options are developed as the instrument does not pick and choose the technologies to develop but lets the market decide which options are developed first.
- It provides flexibility to businesses about investment timing.
- It guarantees that the environmental objective (the cap) will be met.
- It is a European-wide system that minimises intra-EU competitiveness distortions that national policies cause. It is an instrument that enables linking with other jurisdictions, which can help avoid international competitive distortions.
- It allows price discovery through market forces.

The proposal strengthens the EU ETS as the EU's main climate policy instrument by bringing its targets in line with the EU's 2030 greenhouse gas reduction target.

However, it is the ability of the ETS to create economic scarcity of the emission rights that enables the system to deliver the above-mentioned advantages. In this context, there is one specific concern that needs to be resolved within the ongoing revision of the ETS, which concerns the overlap of the system with the deployment of renewable energy and enhancement of energy efficiency from public support. IETA invites the European Commission to address the possible overlap of policies and to suggest an appropriate solution, to ensure the EU ETS remains the central policy instrument for the EU's climate policy to deliver the decarbonisation of Europe's economy.

3. The emission reduction target & use of international credits

IETA members support the EU's long-term objective of reducing greenhouse gas emissions by 80-95% by 2050 compared to 1990 levels, and believe that the EU-ETS should be confirmed as the central pillar of the EU's climate and energy policy. The legislative proposal to revise the EU-ETS represents the first legislative step to implement the EU's 2030 climate & energy package including a revised cap for the EU ETS beyond 2020, and confirms policy makers' support for ensuring a well-functioning ETS as the main policy instrument. The proposed EU-wide target of reducing GHG emissions by "at least 40%" by 2030 is in line with the lower-end of the EU's ambition. To meet the longer-term EU ambition however, greater effort will be needed. Additional options to reduce emissions cost-effectively should be considered, for example, by accessing international carbon markets, whilst ensuring this does not conflict with a well functioning domestic carbon market.

4. Share of auctioning vs free allowances

A key part of IETA's discussions on the proposal will focus on the distribution of allowances between the share to be auctioned (57%) and the share to be allocated for free.

5. Protecting against the risk of carbon leakage

IETA believes that rules to address both direct and indirect emissions costs, to protect against the risk of carbon leakage form an important part of the revision of the EU ETS. We will be further analysing the impacts of the new rules for different sectors, including the extent to which they respect the principles spelt out in the explanatory memorandum of the proposal that "predictable, robust and fair rules for free allocation of allowances to industry to address the potential risk of carbon leakage in an adequate manner" should be developed. We will support the co-legislators in ensuring the rules provide some support for the sectors at risk of carbon leakage, whilst not putting into question the well-functioning of the EU ETS.

IETA would welcome further information from the European Commission on which sectors would likely be eligible to receive free allowances under the proposed new carbon leakage rules, as well as information on the share of industrial emissions these sectors represent. Whilst we understand that this data cannot be confirmed until after 2017 as the new carbon leakage list will depend on the average data from 2013-17, it would be useful to get an estimate, based on the most recent production data (2014 for instance). Such information would be extremely helpful for IETA members as they try to understand the impacts of the proposed rules.

In addition, further clarity would be welcome about the implementation of the benchmark reduction of 1% each year until the middle of the "relevant period of free allocation" and whether this corresponds to the whole of Phase IV or 2021-2025 and 2026-2030. As a result, the baseline year for determining the middle of such a period remains unclear. There is a lack of clarity on certain parts of the proposal, such as the proposed flat rate update of the benchmarks, or the update of the reference activity levels and the increases/decreases of production, which means it is difficult to analyse its impact.

6. The new funds

There are few surprises with the new funds, as they reflect what was agreed by the Heads of States in the European Council Conclusions from October 2014. The design of the envisaged funds (the New Entrants Reserve, the Modernisation Fund, the mechanism enabling transitional free allocation for the modernisation of the energy sector, and the Innovation Fund) should build on expertise gained in such previous mechanisms. Regarding the Modernisation Fund and the purpose it serves to address, we recommend sharing best practices and lessons learnt from the current implementation of the transitional free allowances. Care should also be taken when introducing such mechanisms to avoid them undermining efforts to rebalance supply and demand, particularly at the beginning of Phase IV.

IETA urges the Commission to provide greater clarity on the implementation of the funds to assess their market impact, particularly when the allowances from the innovation and modernisation funds will come to market, and how many allowances would be auctioned in one go. Clarity on the timing and amounts of allowances to be monetised is important as early as possible, in order to enable the market to adapt, and avoid creating shocks by the monetisation of these funds. We would favour a gradual monetisation of allowances throughout Phase IV, rather than frontload the monetisation at the start of the Phase, as this could worsen the supply-demand balance and undermine the purpose of the Market Stability Reserve (MSR), as well as cause challenges relating to liquidity in the market.

In order to fulfil their role, the funds should be tailored to the needs of the eligible Member States to the extent possible.

The **modernisation fund** and the derogation to the power sector under Article 10c were part of the political negotiations to reach an agreement on the EU's 2030 climate and energy package.

The **innovation fund** is a welcome proposal to fund innovative low-carbon technologies of products/processes, including its extension to the industry sector. The proposal to increase the maximum funding rate should be up to 75%, as suggested in the impact assessment accompanying the legislative proposal. We welcome the proposal to increase the phases covered by the innovation fund, including the extension to a pilot stage.
Moreover, we support the idea of the Commission adding criteria for the screening of projects, beyond the cost per unit performance ranking (CPUP).
We welcome the fact that the eligibility of such a fund is enlarged to any type of low carbon technology.

Clarity will be needed as early as possible on the criteria for determining eligible projects, such as what 'commercially viable' means, and what constitutes 'geographically balanced locations'.

7. The validity of EU allowances

We welcome the proposal to simplify some of the rules in the ETS Directive, such as removing the validity of allowances (EUAs) for a specific trading period only. Linking EUAs to a specific trading phase made sense when EUAs were linked to AAUs, but this is no longer relevant going forward. Market participants support the proposal to issue EUAs without a specific vintage, as this is a step towards simplifying the rules of the ETS. Other technical changes, such as the length of the next trading phase serve to further strengthen the EU ETS by facilitating its adjustment to the EU's 2030 framework.

8. Unallocated allowances

IETA has recommended earmarking unallocated allowances, in order to have a discussion about their possible use in Phase IV of the EU ETS[1]. The impact assessment identifies useful options, such as using them for the new entrants' reserve for Phase IV, using them for the innovation fund, using them for compensating against indirect costs, or cancelling them altogether. IETA will be analysing these various options and assessing their pros and cons in light of a well-functioning EU ETS.

It is important to ensure that all allowances not allocated for free by 2020, including de facto 'unallocated allowances' due to the application of a carbon leakage factor for sectors not on the carbon leakage list, are included in the sum of unallocated allowances and not released into the market during the period up to 2020.

The reference to 145million allowances not being allocated to sectors not on the carbon leakage list causes confusion, as there is no explanation as to why unallocated allowances resulting from the carbon leakage factor are able to accumulate until 2020. Further clarification would be helpful on the legal reference as to why these allowances are to be auctioned in 2020 instead of being auctioned throughout Phase 3. In this regard, we would also appreciate a more detailed description of how the Commission reaches the estimate of 145 million allowances.

9. Other comments

- **Ear-marking of revenues**

From a broader perspective of funding low carbon transition, the proposal puts stronger emphasis on earmarking the use of revenues from auctioning. IETA Members believe that earmarking can significantly contribute to the decarbonisation of the ETS sectors, and welcomes the stronger wording in the proposal.

- **Extension of the scope**

The proposal does not refer to the extension of the ETS to other sectors of the economy, which should form part of the discussions in view of increasing the pool of emission reduction opportunities under the ETS and minimising distortions between sectors. The European Commission listed the topic of extending the scope of the EU ETS in its Carbon Market Report in 2012. It is one idea that will require a detailed

[1] https://ieta.wildapricot.org/resources/EU/2030-Package/ieta_unallocated_allowances_19.03.2015.pdf

and informed discussion and should form part of the dialogue on the rules affecting the EU ETS for the period post-2020.

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