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Germany and the EU ETS

Industrial leaders champion a strong EU climate law **Sep 2016**

Saving the EU ETS will take German leadership

The EU carbon market is broken for all the wrong reasons. Successful advances in the *Energiewende* agenda across Europe now require adjustment of the EU Emission Trading System (EU ETS) to fit with the reality of falling emissions. We have already **accumulated a surplus of more than 1,827MtCO_2e**[1] **and by 2020 emissions look likely to be 13% - 23% below the EU ETS cap**.

While European leaders discuss the EU ETS post-Paris review clause, in light of reductions in emissions from electricity generation that occurred over the last decade, the priority should be enforcing and harmonising the current EU climate legislation. Europe cannot afford to lose control over the EU ETS, at the same time, the reform needs to protect industry that is genuinely exposed to carbon leakage.

Enforcing the current EU ETS legislation

Sandbag expects **the surplus of EU allowances (EUAs) to grow by between 4 and 7.5 billion during 2021-2030**, including allowances held in the Market Stability Reserve (MSR). The surplus has been increasing largely due to **emission reductions in Member States' energy sectors driven by growth in renewables and energy efficiency measures**, among other factors.

We encourage German Ministers to take more responsibility for past emission reductions and propose as a part of their Government's position that:

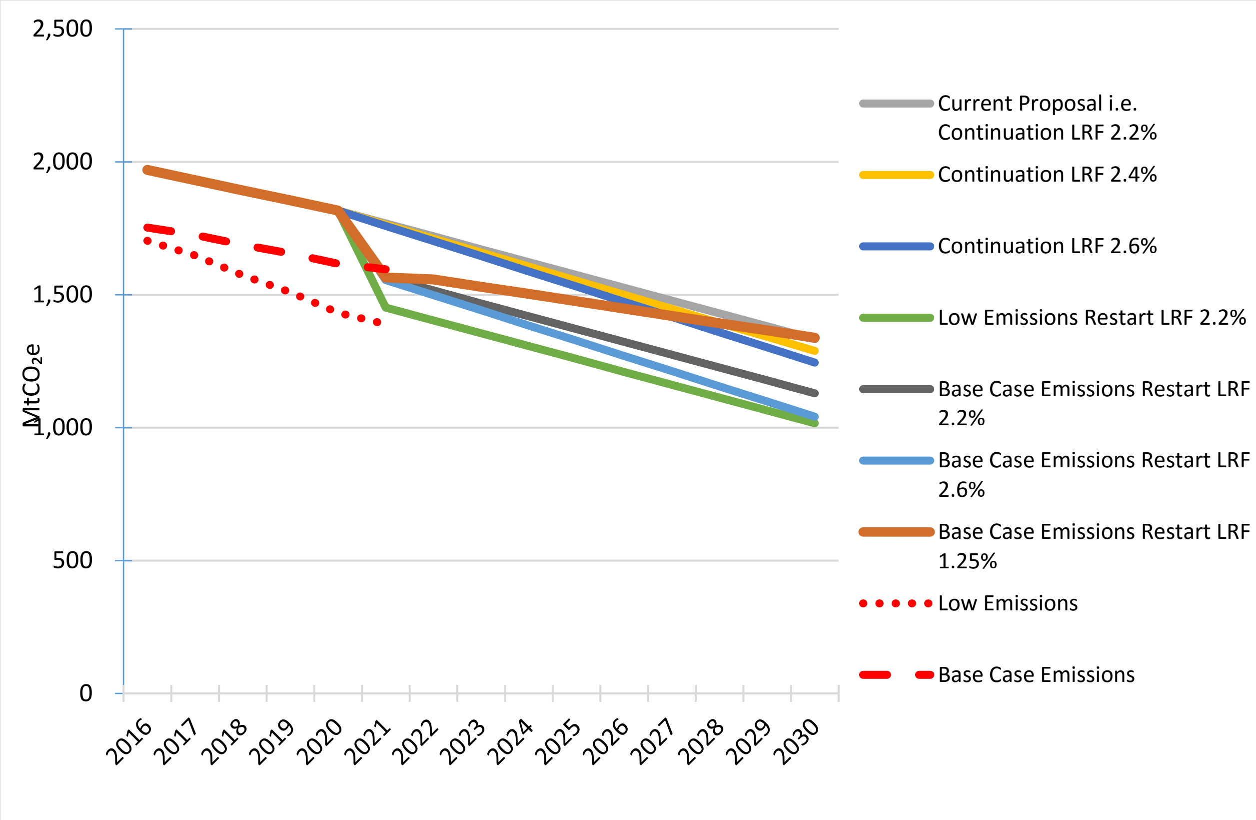
- **the EU ETS Phase 4 starting point in 2021 is based on actual emissions in 2019 or 2020;**
- **the MSR is stabilised through a provision for a size limit of 1 billion allowances in the MSR (10 years' worth of the return rate).** Any allowances above this threshold should be retired.

Rebasing the cap and setting an MSR threshold are measures that are not dependent on any forecast of emissions and would bring the market in line with a real-world set of variables. The Commission has recognised that advantage of rebasing in its new proposal for the Effort Sharing Regulation – a governance framework for emission reductions in the non-ETS sectors.

Chart 1 illustrates how **rebasing prevents continuous growth of the surplus in Phase 4 at a significant scale that would occur even without realignment of the cap**. Rebasing could be combined with an increased Linear Reduction Factor (LRF) for even greater emission reductions, and that would be more effective that increasing the LRF alone.

[1] The EU Commission's data at end 2015 (free allocation + auctioned + offsets - emissions).

Chart 1: Options for rebasing the EU ETS cap in 2021



Note: starting point for Phase 4 cap is set at average of 2017-9 emissions adjusted by three years' Linear Reduction Factor to take it to 2021.

If the EU ETS is not realigned with the reality of carbon emissions, the surplus will continue to grow into Phase 4 and the EUA price will remain too weak to deliver emission reductions through to 2030. This will reduce Member States' willingness to rely on the system in the long term and the EU's ability to meet its 2050 climate goal cost-effectively.

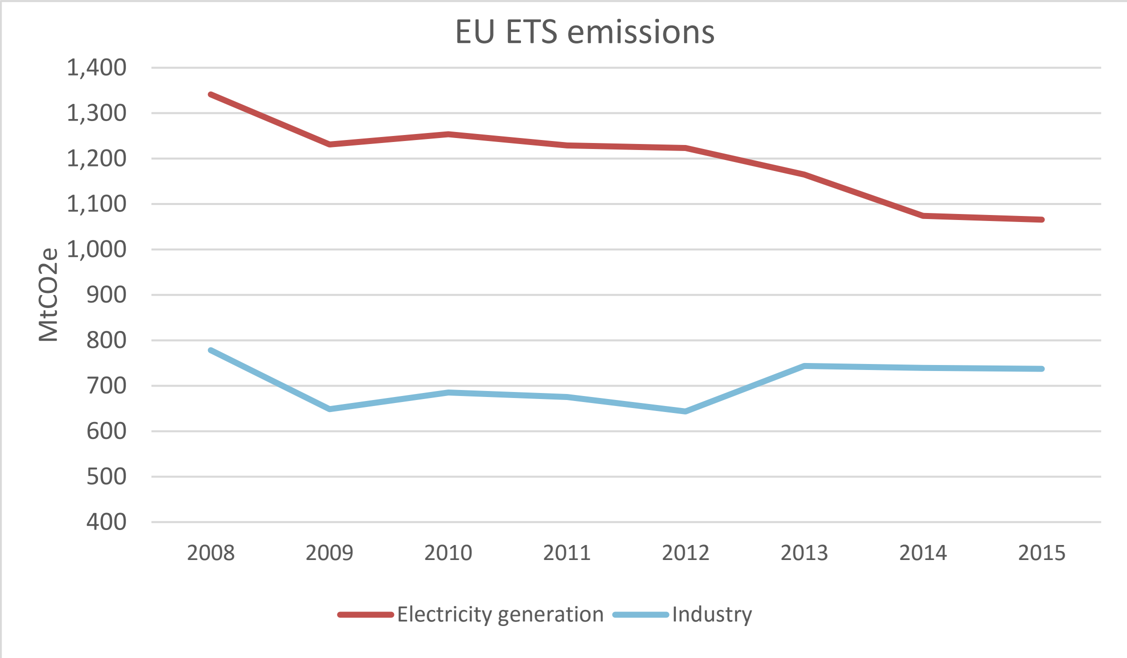
For more information on these options, please see our reports Getting in touch with reality[2] and Stabilising the Market Stability Reserve[3]. There are also other policy options to bring the EU ETS more in line with reality, such as controls on EU ETS prices, that can be additionally considered.

Protecting Germany's industrial base

The impact of the **changes to the cap could be restricted mostly to the power sector where emissions have fallen at the fastest rate during this decade** – a fact recognised by the main European power sector stakeholders who support a range of EU ETS reform amendments on rebasing the cap[4]. **Chart 2**, shows the decreasing trend in EU emissions from electricity generation and compares it with industrial emissions.

[2] https://sandbag.org.uk/reports/getting-touch-reality/.
[3] https://sandbag.org.uk/reports/stabilising-market-stability-reserve/.
[4] Companies supporting rebasing and other changes to trajectory of the cap include: CEZ Group, Dong Energy, EDF, Vattenfall, EDP, Enel, Fortum, Iberdrola, and Statkraft.

Chart 2: Disproportional fall in EU ETS power sector emissions versus industrial emissions



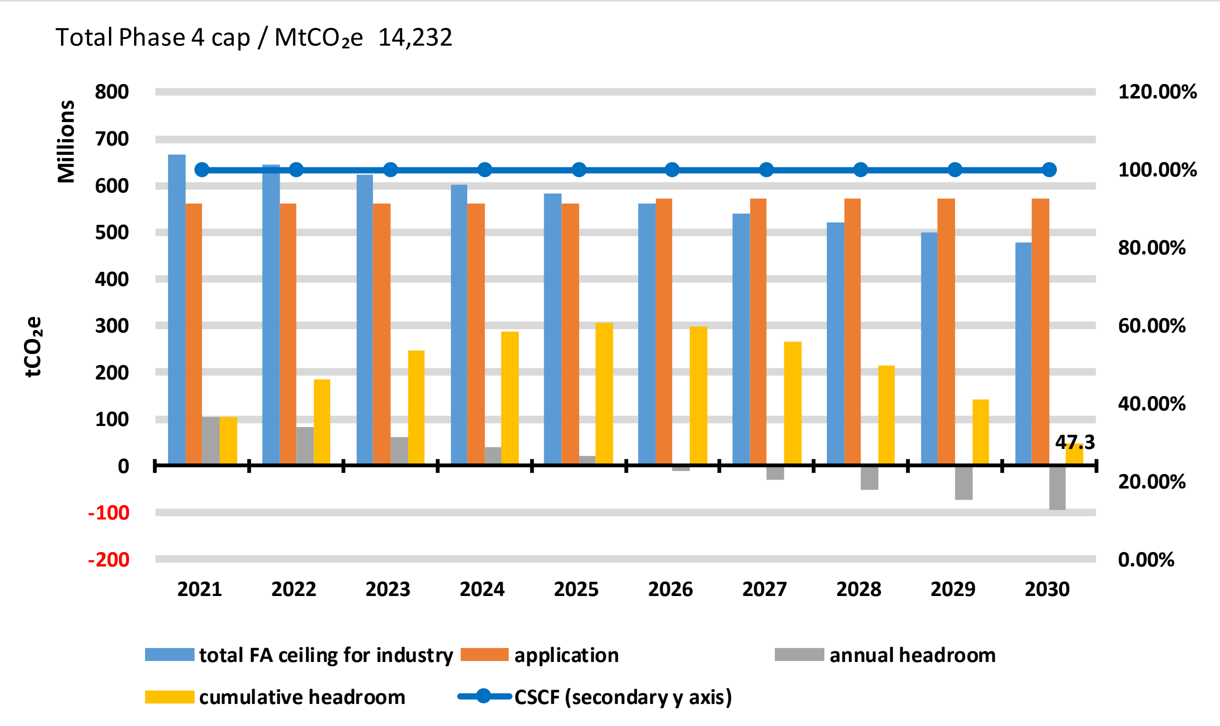
Note: Data on industrial emissions is not directly comparable since the scope of the EU ETS was increased in 2013.

To account for the difference between the rate of emission cuts in power and non-power sectors, **rebasing could be restricted to the auctioning share of the Phase 4 cap – that would leave the amount of free allocation for German industry unchanged**. Otherwise, Sandbag has found in our forthcoming analysis that an **application of the Cross Sectoral Correction Factor (CSCF) to the industry share can be avoided even alongside a tightening of the overall cap and significant industrial growth.** There are many possible parameter combinations, which achieve this, one of them presented in **Chart 3**, below.

The combination presented in **Chart 3** allows for 1% activity growth, preferential treatment to Iron & Steel, Cement, Refined Petroleum, Organic Chemicals & Fertilisers regarding their technology benchmark update, at the same time as addressing the surplus by reducing the Phase 4 cap.

Under this scenario **in Phase 4 German industry would receive the highest share of free allocation as a single Member State amounting to 21.11% of the total cap for free allocation**. In the current Phase 3 Germany receives about 19.95% of the total free allocation share.

Chart 3: Options for avoiding Cross-Sectoral Correction Factor



Note: Comparing total available free allocation to industrial participants per year to the sum of their benchmarked applications for tiered distribution[5] *with -1% benchmark reductions per annum (except for -0.5% for 24.10 Iron & Steel, 23.51 Cement, 19.20 Refined Petroleum, 20.14 Organic Chemicals & 20.15 Fertilisers) and with* ***1% growth for all sectors; the cumulative headroom remains positive and a CSCF is avoided even with a lower cap as a result of lowering the start value to which a 2.2% LRF is applied to 1,689MtCO₂e;*** *the auction share is left at 57%, the NER is taken from Ph4 and the Innovation Support is taken from Phase4 auction share.*

Finally, our analysis shows that **Germany would benefit from changes that provide targeted carbon leakage protection in Phase IV, irrespective of the implementation of the re-basing proposal**. Under the Commission's current proposal, significant benchmark reductions will be needed to avoid a CSCF for any economy-wide growth scenario if the current binary approach to carbon leakage, where installations are either exposed or not exposed, is continued post 2020.

Sandbag's modelling

This briefing is based on Sandbag's previous analysis published in the reports Getting in touch with reality[6] and Stabilising the Market Stability Reserve[7] and analysis of Phase 4 free allocation which will be published very shortly. We used the EU Transaction Log Phase 3 data (taken in May 2016) to identify benchmarked free allocation applications at the installation level and EU Commission's May 2014 mapping of installations to NACE sectors. For more detail on the methodology please contact Tricia Buckley at tricia@sandbag.org.uk.

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[5] *100% 1.6, 75% 0.9, 50% 0.2, 0% rest*

[6] https://sandbag.org.uk/reports/getting-touch-reality/.

[7] https://sandbag.org.uk/reports/stabilising-market-stability-reserve/.

About Sandbag

Sandbag is a London and Brussels-based not-for-profit think tank conducting research and campaigning for environmentally effective climate policies.

Our research focus includes reforming the EU Emissions Trading System and the Effort Sharing Regulation; accelerating the phase-out of coal in Europe; deep decarbonisation of industry through technologies including Carbon Capture & Storage.

For more information, visit our website at www.sandbag.org.uk or email us at info@sandbag.org.uk.

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