# Responding to the ETS

Initial feedback to the Commission's draft proposal **September 2015**

## Introduction

This document represents Sandbag's official feedback to the Commission's proposal to revise the ETS Directive.

Sandbag published two reports over July and August providing our main recommendations for the ETS Revision: *'Harder, Better, Faster, Stronger'* and *'Discharging a Political Storm'*. In this document, we aim to summarise the most important of these recommendations, and update them in light of the published proposal.

Both reports are attached in full as appendices to this document.

## About Sandbag

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

Our research focus includes the phase-out of old coal in Europe; deep decarbonisation of industry through technologies including Carbon Capture Utilisation & Storage; reform of the EU Emissions Trading Scheme; and increasing ambition in the EU 2020 and 2030 climate & energy packages.

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

We divide our recommendations into three themes: environmental ambition, competitiveness, and modernisation/innovation

## 1. Environmental ambition

### 1.1 The ambition of the ETS cap

The Commission's draft legislation proposes revising the Linear Reduction Factor governing stationary sectors of the ETS from 1.74% (or 38Mt a year[1]) currently, to 2.2% (or 48Mt a year) from 2021. The Impact Assessment explains that this will deliver the equivalent of 556 million tonnes of saved CO2e over the decade 2021-2030. This cap is in line with the ETS delivering emissions reductions of 43% below 2005 levels by 2030, which the Commission has calculated is the cost-effective burden for the ETS to bear compared with the non-traded sector under the pledge to cut economy-wide emissions by at least 40% domestic compared with 1990 levels.

**While we welcome this progress, we find that it is inadequate in two key respects. We contend that the proposed cap:**

- **Fails to keep pace with emissions reductions on the ground, and**
- **Remains incompatible with Europe's long-term climate goals.**

That the proposed cap is failing to keep pace with emissions reductions on the ground is demonstrated by the fact that stationary emissions in 2014 were already below their cap for 2020. Under Sandbag's emissions forecast for stationary EU ETS sectors this trend will continue. We expect emissions of around 1,443 million tonnes in 2020. The ETS cap is not due to reach this level until 2028. Worse, by 2020 we expect the ETS to have accumulated some 4.4 billion surplus allowances, a volume dwarfing the 556 million tonnes of additional ambition proposed. Assuming

[1] Under current scope of the EU ETS.

emissions in the non-traded sector evolve as the European Environment Agency predicts, this would imply Europe's domestic emissions economy wide would be 29% below 1990 levels by 2020.[2]

This is not the product of Europe over-delivering against its fair and cost-effective contribution, but rather a symptom of inadequate targets. The long-term goal agreed by European Council as the fair and scientific contribution from Europe is to cut emissions by 80-95% by 2050. That goal is derived from Box 13.7 in the 4th IPCC report. That same report specifies rich countries should reduce emissions by 25-40% in 2020. This has not been reflected in our 2020 target or in the Phase III ETS budget. Moreover, when the Low Carbon Roadmap calculated the cost-effective trajectory to that long term goal, a -25% *domestic* target by 2020 was deemed the appropriate milestone. The failure to enshrine a -25% domestic 2020 target in law has contributed billions of additional allowances in the ETS. This has been outpaced by emission reductions on the ground leading to large surpluses.

Finally, irrespective of the question of ambition, it remains unclear that a -43%/-30% split between the traded/non-traded sectors remains the cost-effective division in light of the large (and growing) surpluses in the EU ETS. The ETS might be better placed to take up more of the burden.

**We recommend that an additional paragraph should be written into the ETS directive to execute a one-off cancellation of allowances from the Market Stability Reserve.** Cancelling 1.5 billion allowances from the MSR would be equivalent to upgrading the 2020 target to 25% below 1990 levels: a target more compatible with equity, cost-effectiveness and emissions reductions on the ground. This would increase the ambition of Europe's carbon budgets with minimal effect on the carbon price, minimal cost to ETS sectors and to EU consumers.

## 1.2 Creating opportunities to ratchet up ambition over time

### 1.2.1 Preparing for and responding to Paris

The legislative timetable should provide sufficient opportunity to revise the ETS (and the ESD) budget in light of a strengthened EU offer coming out of the Paris negotiations. **Our ambition report explores how a stronger 50% EU target (45% domestic/5% international) could be adopted for 2030 through a stronger Linear Reduction Factor in combination with a centralised purchase of high quality offsets.** We propose an important safety valve by which additional *domestic* effort could be scaled back if it proves too costly.

### 1.2.2 Increasing ambition beyond Paris

The proposed revision fails to introduce clear measures to increase ambition in light of new scientific or political developments subsequent to Paris. Indeed the ETS revision *reduces* the opportunities for policymakers to review the ambition of the scheme by lengthening the budget periods from eight years to ten years.

- **We propose that the ETS revision revert to 5-year budgets, providing more opportunities to review ambition in light of new scientific, political, technological and economic developments.**

- **We also propose introducing automatic ratchets which cancel allowances from the MSR after they have stayed in the reserve beyond a certain period, or if a certain volumetric threshold is exceeded.**

- **We also recommend introducing measures which better enable EU Member States to unilaterally increase ambition by cancelling their auctionable allowances**.

## 1.3 Promoting scarcity of supply within the cap

[2] https://sandbag.org.uk/site_media/pdfs/reports/Press_briefing_on_EEA_release.pdf

### 1.3.1 Maintaining the integrity of the Market Stability Reserve

Independent of the question of headline ambition in the ETS budgets there is the question of maintaining scarcity of supply to ensure long term cost-effectiveness and intertemporal efficiency beneath the cap. We have just emerged from a protracted debate concerning a market stability reserve designed to regulate the supply of allowances on the market. It is worrying that allowances due to enter the Market Stability Reserve are *already* being proposed for release back into the market or re-assignment to other purposes. This sets a dangerous precedent, which could damage the market's confidence in the integrity of the reserve.

The Commission proposal looks to remove 50 million from the reserve to bridge a gap in innovation funding. It also proposes to remove 250 million more allowances to populate the Phase IV New Entrants Reserve. Finally, around 150 million unallocated allowances will be placed in the New Entrants Reserve which we previously believed had been captured by the MSR. **This would leave approximately 450 million fewer allowances in the Market Stability Reserve than we had counted on. This increase in supply cancels out much of the additional scarcity promised by the proposed change to the linear reduction factor.**

A proposed change to Article 10a(8) regarding innovation funding reads: "In addition, 50 million unallocated allowances from the market stability reserve established by Decision (EU) 2015/… shall supplement any existing resources remaining under this paragraph for projects referred to above, with projects in all". Moreover sweeping change are introduced to Article 10(7) concerning the New Entrants Reserve:

| **Proposed revision to Article 10a(7). First subparagraph** | |
|---|---|
| **Current text** | **Text proposed by the Commission** |
| 7. ~~Five percent of the Community-wide quantity of allowances determined in accordance with Articles 9 and 9a over the period from 2013 to 2020 shall be set aside for new entrants, as the maximum that may be allocated to new entrants in accordance with the rules adopted pursuant to paragraph 1 of this Article. Allowances in this Community-wide reserve that are neither allocated to new entrants nor used pursuant to paragraph 8, 9 or 10 of this Article over the period from 2013 to 2020 shall be auctioned by the Member States, taking into account the level to which installations in Member States have benefited from this reserve, in accordance with Article 10(2) and, for detailed arrangements and timing, Article 10(4), and the relevant implementing provisions.~~ | 7. Allowances from the maximum amount referred to Article 10a(5) of this Directive which were not allocated for free up to 2020 shall be set aside for new entrants and significant production increases, together with 250 million allowances placed in the market stability reserve pursuant to Article 1(3) of Decision (EU) 2015/… of the European Parliament and of the Council(*). From 2021, allowances not allocated to installations because of the application of paragraphs 19 and 20 shall be added to the reserve. |

While some 400 million of these unallocated allowances will remain off the market in a reserve for New Entrants, if left unchanged the ETS Directive would have seen the New Entrants Reserve populated with *new* allowances from the Phase IV cap. The aspect of the proposal therefore represents a step backwards in terms of addressing scarcity.

**We recommend that all of these unallocated allowances should either be cancelled or should stay in the Market Stability Reserve. Moreover, 400 million new allowances from the Phase IV cap should be dedicated to the Phase IV New Entrants Reserve.**

### 1.3.2 Preventing the NER from flooding the market at the end of Phase IV

Under the proposed changes to Article 10a(7) cited above, the Commission proposes to divert any unallocated allowances returned by facilities that have reduced their activity towards the New Entrants Reserve. This helps to keep excess allowances off the market in a clearly defined location, where they can later be drawn on to fund growth in activity levels.

The new proposal also appears to terminate the current provision to automatically release unused New Entrants Reserve allowances to the market at auction at the end of each period, suggesting that allowances in the New Entrants Reserve will stay there indefinitely. **This is an important measure to prevent unallocated allowances from flooding the market at the end of each trading period, and is therefore welcomed. However, we would prefer that some or all of the New Entrants Reserve was cancelled at the end of each period as a means of ratcheting up the ambition of the ETS cap over time.**

### 1.3.3 Driving more allowances into the New Entrants Reserve

Under current legislation if industry's benchmarked free allowances are less than the maximum free allowances available, any spare allowances are divided between Member States for auction. This is captured under Article 10(1) of the ETS Directive which states "From 2013 onwards, Member States shall auction all allowances which are not allocated free of charge in accordance with Article 10a and 10c." This rule is carried over unchanged in the current ETS revision.

**We propose instead that in the event that industry applies for fewer allowances than are available, any spare allowances should be diverted towards the New Entrants Reserve and/or used to top up innovation funding rather than being redistributed to Member States at auction.** This would help maintain scarcity of supply while maintaining a fund to protect industrial competitiveness as the cap progressively tightens or in case industrial output surges. This change should be possible to introduce via a change to Article10 (7) and/or Article 10(8) concerning the New Entrant's Reserve and the Innovation Fund respectively.

## 2. Competitiveness

The measures in the ETS to protect competitiveness underwent significant improvements between Phase II and Phase III and the new Revision offers an important opportunity for further reforms.

To date the ETS directive has suffered from some inelegant political compromises. Weak bottom-up criteria for free allocation (carbon leakage criteria, production baselines, benchmarks) have required a top-down backstop in the form of an aggressive cross sectoral correction factor to limit over-allocation to many industries. This has potentially led to an unfair distribution of allowances between industries, generating windfalls for many and potentially risking under-allocation to best performers who might be genuinely exposed to carbon leakage. Meanwhile, widespread drops in production against relatively fixed free allocation has also led to over-allocation.

We see this ETS revision as an important opportunity to make the legislation more balanced and more elegant by strengthening the bottom up criteria for issuing free allowances while relaxing the top-down criteria, and making free allocation more responsive to output.  The ~~Commission~~ proposal includes several welcome advances in this direction:

In terms of relaxing top-down criteria, the enforcement of the correction factor has been revised to carry any headroom in the free allowances budget early in the period to offset any shortages earlier in the period:

| **Proposed revision to Article 10a(5)** | |
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| **Current text** | **Text proposed by the Commission** |
| 5. ~~The maximum annual amount of allowances that is the basis for calculating allocations to installations which are not covered by paragraph 3 and are not new entrants shall not exceed the sum of:~~<br><br>~~(a) the annual Community-wide total quantity, as determined pursuant to Article 9, multiplied by the share of emissions from installations not covered by paragraph 3 in the total average verified emissions, in the period from 2005 to 2007, from installations covered by the Community scheme in the period from 2008 to 2012; and~~<br><br>~~(b) the total average annual verified emissions from installations in the period from 2005 to 2007 which are only included in the Community scheme from 2013 onwards and are not covered by paragraph 3, adjusted by the linear factor, as referred to in Article 9.~~<br><br>~~A uniform cross-sectoral correction factor shall be applied if necessary.~~ | 5. In order to respect the auctioning share set out in Article 10, the sum of free allocations in every year where the sum of free allocations does not reach the maximum level that respects the Member State auctioning share, the remaining allowances up to that level shall be used to prevent or limit reduction of free allocations to respect the Member State auctioning share in later years. Where, nonetheless, the maximum level is reached, free allocations shall be adjusted accordingly. Any such adjustment shall be done in a uniform manner. |

In terms of strengthening bottom up criteria Article 10b has been substantially revised so that the Carbon Leakage criteria target fewer sectors, and are less dependent on the vagaries of the $CO_2$ price:

| **Proposed revision to Article 10b (1)** | |
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| **Current text** | **Text proposed by the Commission** |
| **Measures to support certain energy-intensive industries in the event of carbon leakage**<br><br>1. ~~By 30 June 2010, the Commission shall, in the light of the outcome of the international negotiations and the extent to which these lead to global greenhouse gas emission reductions, and after consulting with all relevant social partners, submit to the European Parliament and to the Council an analytical report assessing the situation with regard to energy-intensive sectors or subsectors that have been determined to be exposed to significant risks of carbon leakage. This shal be accompanied by any appropriate proposals [...]~~ | **Measures to support certain energy-intensive industries in the event of carbon leakage**<br><br>1. Sectors and sub-sectors where the product exceeds 0.2 from multiplying their intensity of trade with third countries, defined as the ratio between the total value of exports to third countries plus the value of imports from third countries and the total market size for the European Economic Area (annual turnover plus total imports from third countries), by their emission intensity, measured in kgCO2 divided by their gross value added (in €), shall be deemed to be at risk of carbon leakage. Such sectors and sub-sectors shall be allocated allowances free of charge for the period up to 2030 at 100% of the quantity |

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| | determined in accordance with the measures adopted pursuant to Article 10a. |

Benchmarks will steadily improve over time subject to a standard improvement rate, informed by real data on a five year cycle:

| **Proposed revision to Article 10a(2)** | |
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| **Current text** | **Text proposed by the Commission** |
| | **New:**<br><br>The benchmark values for free allocation shall be adjusted in order to avoid windfall profits and reflect technological progress in the period between 2007-8 and each later period for which free allocations are determined in accordance with Article 11(1). This adjustment shall reduce the benchmark values set by the act adopted pursuant to Article 10a by 1% of the value that was set based on 2007-8 data in respect of each year between 2008 and the middle of the relevant period of free allocation […] |

| **Proposed revision to Article 11(1) Second subparagraph** | |
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| **Current text** | **Text proposed by the Commission** |
| | **New:**<br><br>A list of installations covered by this Directive for the five years beginning on 1 January 2021 shall be submitted by 30 September 2018, and lists for the subsequent five years shall be submitted every five years thereafter. Each list shall include information on production activity, transfers of heat and gases, electricity production and emissions at sub-installation level over the five calendar years preceding its submission. Free allocations shall only be given to installations where such information is provided. |

Finally, ex-post adjustments to free allocation will be improved to better accommodate increases as well as decreases in production, with specific activity thresholds to be determined in secondary legislation:

| **Proposed revision to Article 10a(1) Second subparagraph** | |
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| **Current text** | **Text proposed by the Commission** |

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| ~~Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 23(3).~~ | The Commission shall be empowered to adopt a delegated act in accordance with Article 23. This act shall also provide for additional allocation from the new entrants reserve for significant production increases by applying the same thresholds and allocation adjustments as apply in respect of partial cessations of operation. |

**We welcome all of these advances, but suggest two specific improvements to the correction factor.**

- **First, the correction factor should only correct for allowances industry actually applies for.**
- **Second, highly-exposed best-performers should be exempted from the correction factor with other sectors making up the difference.**

Under existing legislation, the correction factor treats all facilities as if they were due to receive 100% of their benchmarked allocation for free, irrespective of their ultimate carbon leakage status. This both increases the likelihood that the correction factor is triggered and leads to an over-correction. Under existing rules, all sectors are incentivised to pursue carbon leakage protections for themselves and are indifferent to the carbon leakage status of other sectors because it does not affect them. **Changing the way the correction factor is applied would have the virtuous effect of pitting different industrial lobby groups against each other on the issue of carbon leakage exposure, as any sectors offered excessive protections risk pushing down the allocation to other sectors.** The new proposal determines carbon leakage status on the same timeframe as the carbon budget and the ceiling on free allowances (ten years), so there should be no logical barrier to implementing this measure (though, again, a five-year timeframe for both would be far preferable)

Exempting highly-exposed best performers would confer an additional advantage on industry leaders, and provides a guarantee they will not face undue costs. It is very important, however, that “best performers” continue to be narrowly defined.

**We also recommend two changes to the carbon leakage criteria.**

- **Adopt a multi-tiered approach to leakage exposure**
- **Phase out free-allocation to non-exposed sectors**

While the proposal reduces the number of sectors eligible for full carbon leakage protections to around 50, these sectors still represent roughly 90% of emissions in 2014, which still seems excessive. We therefore encourage the Commission to adopt a tiered approach to carbon leakage that better differentiates sectors with very high, high, medium and low (or no) exposure as proposed in the Impact Assessment (where it was highly scored against other alternatives). This will mitigate over-compensation of limited, financially valuable resources (EUAs) to sectors that do not really require it. Moreover, if combined with our recommended reforms to the correction factor, this would greatly reduce the likelihood that a cross-sectoral correction factor will be triggered and also ensure a fairer distribution of limited allowances to all sectors.

We question the need to confer a minimum of 30% of benchmarked allocations for free across the Phase, to sectors which show little or no risk of carbon leakage. In Article 10a(11) the current legislation specifies that free allocation to these sectors would be phased out by 2027, but the new revision proposes to delete this line. We propose reversing this deletion.

Finally, we are exploring the impact of different thresholds for the list of sectors captured by different levels of protection.

## 3. Modernisation and Innovation

Sandbag welcomes the Commission's proposals to increase the scale of the innovation fund to 400 million allowances, and to introduce a complimentary Modernisation Fund to support lower-income Member States. We also salute the explicit language seeking to ensure that Fund's investments "shall be consistent with the aims of this Directive and the European Fund for Strategic Investments", as proposed under Art. 10d(1). As the Fund is carved out of the auctioning pot of all Member States, we agree that having robust, environmentally-minded guidance principles for project eligibility enforced at the EU-level by the Commission, the EIB and a cross-representation of Member States constitutes a sensible policy line.

We hope that policymakers will take advantage of some of the helpful suggestions the Impact Assessment suggests for the Innovation Fund. For instance, the proposal to raise the maximum funding rate under the Innovation Fund to 75% of project costs should make it easier to fund projects in CCS or many first-of-a-kind industrial abatement technologies. We are also agree that projects with challenging upfront capital costs could also benefit if they received funding once pre-defined milestones (e.g. final investment decision, critical construction stages, etc.) had been reached instead of only once 75% of the targeted performance has been demonstrated, as was the case under the NER300 programme.

We still feel, however, that the Commission proposal directs too many allowances towards Member State auctions and free allowances at the expense of innovation funding, and argue that a greater proportion of allowances could be diverted to funding breakthrough technologies. Furthermore, we believe that the use of transitional free allocation for the modernisation of the energy sector under Article 10c should, like the Modernisation Fund, be prevented from runing counter to the aims of the ETS Directive. Admittedly, as 10c allowances come from Member States' own auctioning pots, entrusting the final funding decisions to individual Member States would respect individual government's sovereignty in energy matters. Nevertheless, these allowances are created as a result of the ETS Directive, and therefore it would be counter-productive to allow EUAs to be used to fund climate damaging technologies.

Furthermore, given the small volume of allowances available to some Member States through the Modernisation Fund, as well as potentially very low carbon price resulting from the ETS's chronic oversupply, we recommend allowing Member States to add Article 10c allowances to their pool of EUAs from the Modernisation Fund, as suggested in the Impact Assessment. In this case the funding decision ought to be taken at the EU-level, in accordance with stricter guidelines. This merging of two different sources of aid need not necessarily be an inefficient use of public resources, as many modernisation investments may be too expensive for these less wealthy Member States to fund by means of a single source of aid. Furthermore, multiple Member States should be allowed to pool their Modernisation allowances for given years to fund Projects of Common Interest.

Finally, noting the role of the EIB and the Commission in the NER300 mechanism, as well as their proposed role in the Modernisation Fund, we propose that a single harmonised board, composed of these two bodies and a cross-representation of Member States, run both the Innovation and Modernisation Fund in parallel, awarding funding in accordance to the same transparent eligibility principles. The body should select new projects either once or twice during the two 5-year phases that we propose, ensuring a steady support for innovation and modernisation throughout the 2021-2030 period.

We therefore recommend:

- The Innovation Fund must be increased, and, in particular for expensive technologies, funding streams should be sensitive to project lifecycles.
- Highly GHG-polluting technologies should not be eligible for funding under Article 10c, so that highest abatement technologies receive more support.
- Greater flexibility should be introduced for pooling large sums of money for technology projects, in particular: the pooling of allowances across all three low-carbon funding mechanisms, as well as across

multiple countries. Funding pools should only be made available to projects under the strictest of all eligibility criteria.

- The governance of these mechanisms must be transparent and ensure a steady stream of support for low-carbon technology all the way to 2030.

## About this briefing

We are grateful to the European Climate Fund for helping to fund this work. Full information on Sandbag and our funding is available on our website (www.sandbag.org.uk).

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