sandbag
smarter climate policy

How to optimise EU ETS transition funds?

Analysing options for Article 10c derogations, the Modernisation Fund, and for Solidarity and Growth provisions.

19th June 2019

This year, several EU Member States must make critical decisions on the implementation of the EU Emissions Trading Scheme (EU-ETS) for the whole of Phase 4 (2021-2030). Specifically, qualifying Member States, mostly in Central Eastern Europe, must notify the EU Commission on decisions regarding their use of the Article 10c derogation, the Modernisation Fund and the Solidarity Provision. ***The deadline for this is 30th September 2019****.*

In this short briefing:

- We analyse the small-print from the European Commission[1] to assess the investment options possible for Article 10c and the Modernisation Fund.
- We analyse the available options for each eligible Member State and the financial impact of these decisions. We quantify the action the MSR (Market Stability Reserve) on auction volumes – and how this may change as a result of Member State decisions.

Key Findings

The Modernisation Fund offers much better investment prospects than Article 10c. The new criteria for 10c in Phase 4 are strict, it may be difficult to find eligible projects for allowances set aside for this derogation, leaving them unallocated. Both Article 10c and the Modernisation Fund can't be used for coal investment, however Article 10c has stricter criteria for other investments:

- Article 10c needs at least 30% private financing of the project investment.
- Article 10c doesn't allow participation of innovative start-up companies and green companies (e.g. energy efficiency companies), which has a negative impact on job creation.
- Article 10c can't be used for just transition.
- Under Article 10c, any new capacity built must also result in the decommissioning of higher carbon-intensity capacity (so the construction of renewable capacity requires the closure of existing fossil capacity).

- **There is ambiguity in the Commission text regarding the operation of the market stability reserve (MSR) following transfers out of the direct auction pots (10(2)(a) & 10(2)(b)). However, in every scenario, the optimal decision should always be to maximise the Modernisation Fund.**

Key Recommendation

- **Eligible Member States should maximise their Modernisation Fund by transferring to the fund both the allowances available for the Article 10c derogation and those in the Solidarity & Growth Provision.** This would unlock the widest range of energy transition investments whilst reducing Member State reliance on the need for private finance to support such investments, regardless of how the MSR operates.

[1] See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L0410&from=EN

How useful is Article 10c derogation?

What is Article 10c derogation? Article 10c enables eligible countries to give free EU ETS allocations directly to electricity generating installations to help them "transition". In Phase 3, the derogation was widely used to refurbish coal power plants; however, in Phase 4 this will not be possible. Article 10c is given to certain CEE countries during Phase 3, under a temporary derogation from the general rule of auctioning in the EU ETS, and was only then extended to Phase 4 under tough conditionalities. It would be unlikely this form of concession – mostly to the highly emitting energy sectors in Central Eastern Europe – would be continued past 2030. There is a slight difference in countries eligible from Phase 3 to Phase 4: Cyprus and Malta are out, and Croatia and Slovakia are in.

What are the restrictions on using 10c? The criteria for 10c are very strict. There is a risk that permits set aside for 10c may never all be freely allocated. If they aren't freely allocated, they will be auctioned later during the phase.

We analysed the key differences between Article 10c and the Modernisation Fund and it is clear that the Modernisation Fund is more flexible:

	Article 10c Derogation	**Modernisation Fund**
Who benefits?	Any existing CO2-emitting installation registered in the EU ETS.	Any company.
How are projects funded?	Installations receive free allowances on the condition that the operator invests in a project to modernise the energy sector. The project must be of at least equal value to the value of the free permits and must involve additional private finance. Projects are selected by a competitive bidding process under strict conditions.	Projects are financed by auction revenues from the Modernisation Fund. Eligibility of projects is assessed by an investment committee composing of the EIB and a representative of each beneficiary Member State.
Carbon intensity	Projects shall *"not contribute to or improve the financial viability of highly emission-intensive electricity generation or increase dependency on emission-intensive fossil fuels"*. Also, projects must "realise a pre-determined significant level of CO2 reductions".	*"No support shall be provided to energy generation facilities that use solid fossil fuels."* Although with a derogation for Romanian and Bulgarian district heat - *see discussion below*.
Financing requirement	Up to 70 % of the relevant costs of an investment may be supported using the free allocation, so at least 30% of the project must be financed privately.	Full value of most investments can be funded from the Modernisation Fund (some must have a minimum 30% financed privately).
Timescales for MS (additional to the Sep-2019 deadline)	By June-2019, MS must notify EC: - For large projects: publish a detailed national framework setting out the competitive bidding process for public comment. - For small projects: establish, publish and submit to the Commission a list of investments.	-

What investment opportunities can be supported via Article 10c? It's clear that 10c has limited options for investment, whereas the Modernisation Fund allows investment in many more areas.

<table>
<tr><th></th><th>Article 10c</th><th>Modernisation Fund</th></tr>
<tr><td>Coal</td><td>No (implicitly). Projects shall "not contribute to or improve the financial viability of highly emission-intensive electricity generation or increase dependency on emission-intensive fossil fuels".

Using 10c for refurbishment of coal units would clearly not be possible (esp. for SO2/NOx abatement which doesn't also "realise significant CO2 reductions").

Using 10c for new coal units would likely fail, both on the carbon-intensity criteria when applied over the lifetime of the new coal plant, and on the criteria that investments supported shall be "consistent with [..] reaching the long-term objectives of the Paris Agreement".</td><td>No (explicitly): "No support shall be provided to energy generation facilities that use solid fossil fuels."

There is an exemption for Romania and Bulgaria that could allow investments into "efficient and sustainable district heating" powered by coal (despite them still receiving free allocation in Phase 4). 30% must be funded privately.</td></tr>
<tr><td>Biomass</td><td>Yes, although unlikely to allow co-firing with coal or conversion of a coal unit to biomass. That's because the carbon-intensity criteria above still applies. Both co-firing and converting a coal unit would likely result in "improving the financial viability" of a coal plant.</td><td>Yes, but not at a coal plant. The "solid fuel" criteria does not allow co-firing with biomass, and is unlikely to allow coal plant conversion to biomass. However, both may be possible for "efficient and sustainable" Romanian and Bulgarian coal-powered district heating plants.</td></tr>
<tr><td>Gas</td><td rowspan="3">Yes, but with more restrictions than 10d:

Investments that result in new generating capacity must lead to decommissioning of the same amount of capacity of a higher carbon intensity - e.g. to build wind or gas you must close higher-carbon capacity like coal.

10c can only cover up to 70% of the investment value; so at least 30% must come from private investment.

Excludes new start-ups and green companies: 10c investment is only open to EU-ETS registered companies, which must meet a minimum CO2 emitting threshold. For example, an energy efficiency company couldn't apply for 10c. Likewise it would exclude many other innovative companies that are needed to help with modernisation.

Ironically, it may also exclude utilities with coal, as the investment must not "improve the financial viability" of a company's coal plants.</td><td>Yes. But there is some ambiguity over some gas investments (e.g. a new gas power plant) which may sit outside the definition provided under Paragraph 2 in the Mod Fund text. Investments outside Paragraph 2 require 30% private investment and an assessment of the emission reduction it achieves; also a maximum of 30% of the ModFund can be spent on these type investments.</td></tr>
<tr><td>Wind + Solar</td><td>Yes.</td></tr>
<tr><td>Energy efficiency, storage, networks, etc.</td><td>Yes. It specifically encourages "energy storage, modernisation of district heating pipelines, grids for electricity transmission and the increase of interconnections, and energy efficiency in transport, buildings, agriculture and waste."</td></tr>
<tr><td>District heating</td><td>Yes. Although only by an EU-ETS registered company, which may only cover the boiler, and not the other parts of district heating to improve pipelines and possibilities for energy efficiency.</td><td>Yes. 10d can be used to invest in any or all value areas of the CHP: the boiler, pipelines, and energy efficiency possibilities.</td></tr>
<tr><td>Just transition</td><td>No.</td><td>Yes. "To support a just transition in carbon-dependent regions, so as to support the redeployment, re-skilling and up-skilling of workers, education, job-seeking initiatives, in dialogue with the social partners."</td></tr>
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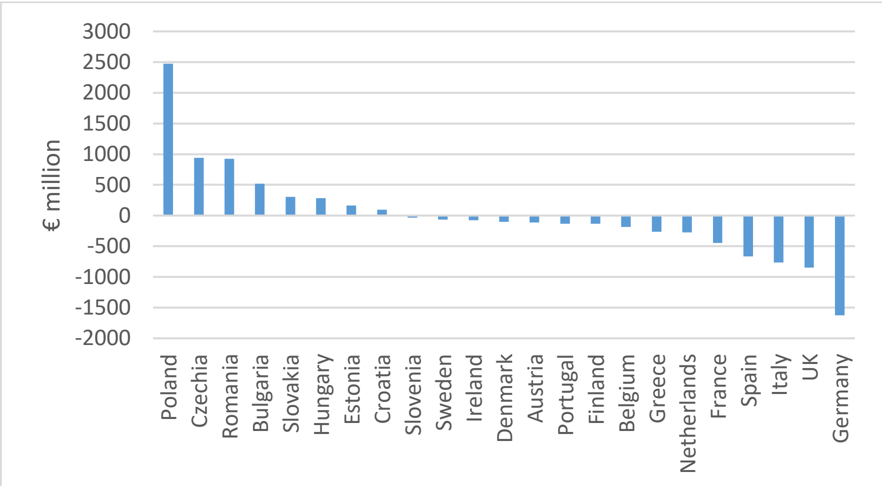
Awaiting clarification on the functioning of the MSR: how important is it?

There is ambiguity in the Commission text around how the MSR acts on different portions of countries' shares of allowances for auctioning. Depending on how the MSR acts, eligible countries could benefit (via a reduced contribution to the MSR) by transferring allowances eligible for the Article 10c derogation and/or Solidarity and Growth allowances to the Modernisation Fund instead of directly auctioning them themselves.

The issue is: "*is the split of the MSR withdrawal amounts across the countries recalculated to reflect the new distribution of allowances for auctioning **after** any transfers – or – is the original distribution of allowances for auctioning under Article 10(2)(a) and (b) applied for the MSR withdrawals regardless of any transfers?*"

Sandbag has modelled the potential impact of an MSR split recalculation – see Figure 1. There are winners and losers: for every permit that a Modernisation Fund eligible MS pays less into the MSR, a non-eligible MS would need to pay more (in total it is a zero-sum game). Poland, Czechia and Romania would benefit most, with Germany and the UK losing the most. This is based on Sandbag's base emissions scenario; the impact of an MSR split recalculation would be even greater under Sandbag's High Ambition emissions scenario due to greater MSR withdrawals[2].

Figure 1: Winners and Losers of an MSR recalculation (2021 to 2030): *Impact if an MSR recalculation happened, in a hypothetical scenario where every country had transferred all their Article 10c and Solidarity provision into Modernisation Fund. Assumes EU ETS price of €30/tonne of CO2. Selected countries only.*



Sandbag anticipates that transfers from MS auctioning to Article 10c free allocation are less likely to lead to recalculation of the split of the MSR withdrawals than transfers to the Modernisation Fund. Why? Because there is precedent – choices on Article 10 use did not impact MS contributions to the allowance volumes held back from auctioning during Phase 3 under the Backloading Decision. However, given the wording of the ETS Directive and the MSR Decision, it seems reasonable to assume that transfers to the Modernisation Fund may be handled differently. ***So, Sandbag recommends MS to transfer all allowances eligible under the 10c derogation to the Modernisation Fund.***

What if the MSR split is not recalculated? Under this outcome, the same government money in total is available to the MS regardless of whether they choose to auction directly themselves or to maximise their share of the Modernisation Fund. However, maximising the Modernisation Fund will channel the money into modernisation of the energy industry faster and more efficiently than using auction revenues. Why? Because unlike the Modernisation Fund, MS use of auction revenues is subject to "state aid" controls. Therefore, given that the modernisation requirements of every country vastly exceed the "basic" Modernisation Fund, **regardless of how the MSR acts, the best option is to maximise the Modernisation Fund.**

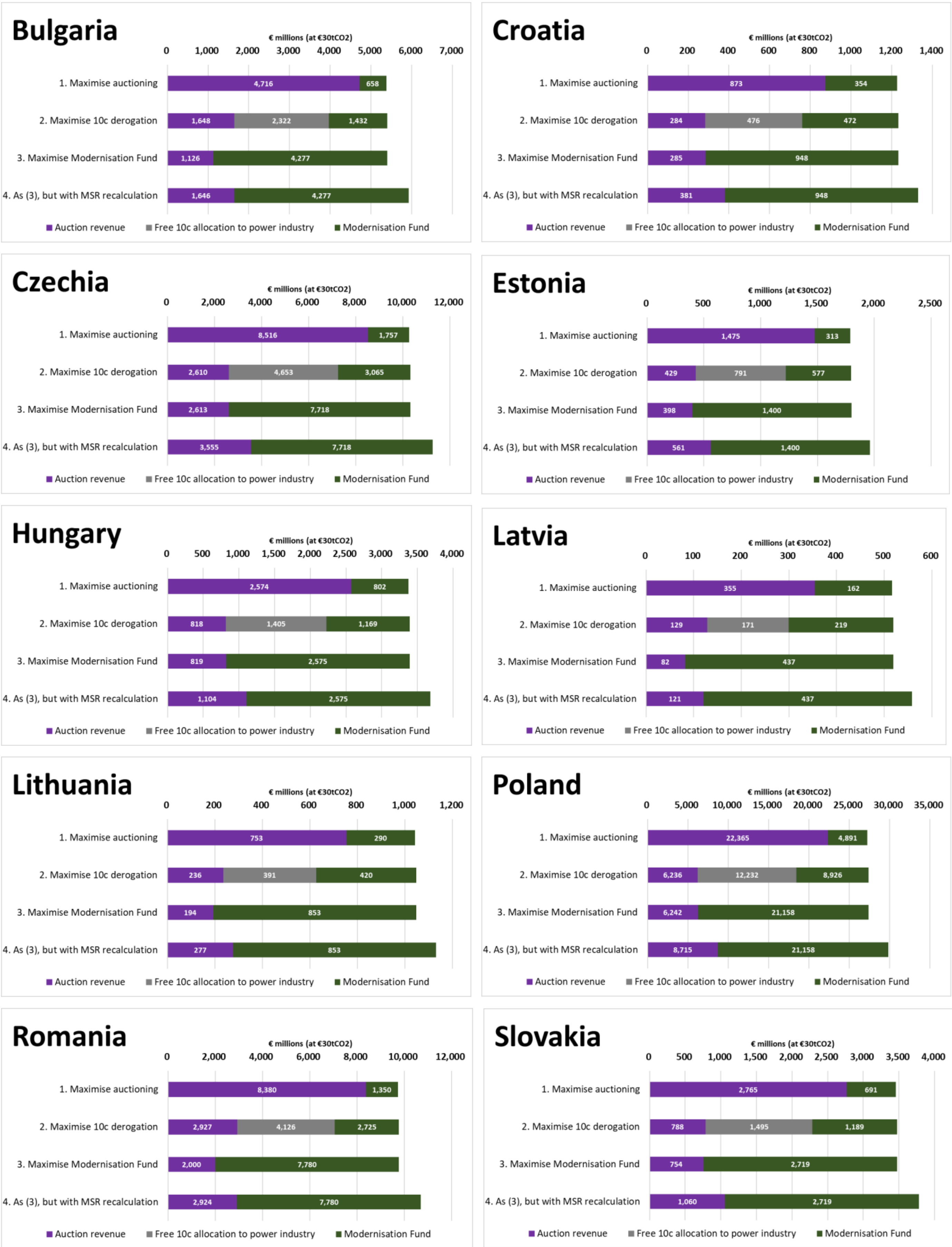
[2] See our "Halfway There" report for more detail on the emissions scenarios.

Quantifying the choices

We consider four scenarios for every eligible country.

1. **Maximise auctioning**. This is achieved by ignoring the option to freely allocate or transfer Article 10c allowances as well as ignoring the option to transfer Solidarity allowances.
2. **Maximise Article 10c derogation**. Give away MS auction shares as free allocation to electricity generators. The rules require that this is accompanied by some transfer to the Modernisation Fund (i.e. 40% transfer from Art10(2)(a) plus rest to 60% from Art10(2)(b)). This would dramatically reduce auction revenue. Assumes no carryover from Phase 3.
3. **Maximise Modernisation Fund**. This involves transferring both the Article 10c and Solidarity Provision to the Modernisation Fund. This would reduce direct MS auction revenue, but maximise the money that can be quickly deployed to the MS to modernise their energy system.
4. **Maximise share of Modernisation Fund – split of the MSR recalculated**. The scenario is as (3), however, due to an MSR split recalculation as described in the previous section - those countries which choose to maximise their share of the Modernisation Fund gain the added benefit of reducing their contribution to MSR withdrawals – thus boosting their overall auction revenues.

Figure 2: Quantifying the fund decisions for Member States (2021-2030)

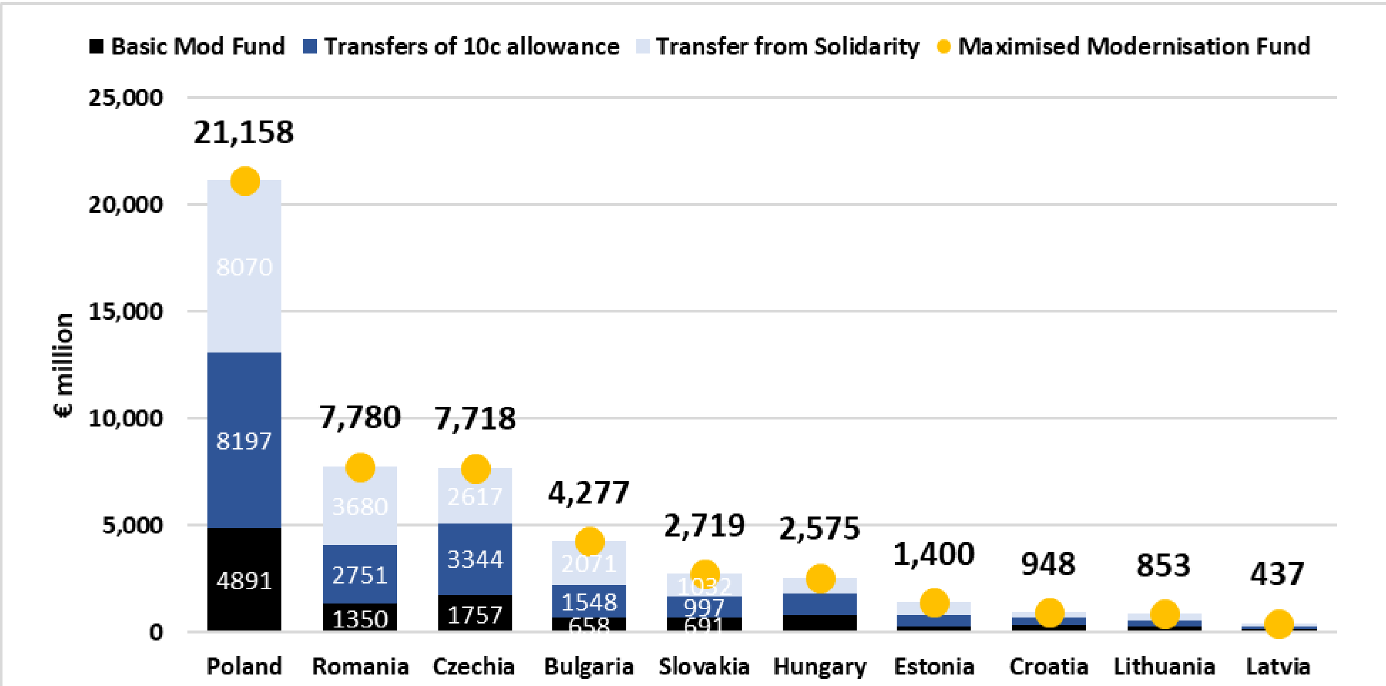


Maximising the Modernisation Fund?

The Modernisation Fund is a Fund created exclusively for Phase 4 of the EU ETS, from 2021-2030. It supports the modernisation of the energy as well as other key sectors in the MS with a GDP below the EU average. The Modernisation Fund was created as a transition bridge to support the wider investments into the energy sectors in order to pave their way towards a modernised energy system

Maximising the Modernisation Fund would swell it from €11 billion to €50 billion (see figure 3). The Modernisation Fund - before any additional transfers - is worth €11 billion, at a €30/tCO2 price. Transferring in all the Article 10c derogation and Solidarity Provision would swell the value of the Modernisation Fund to €50 billion, making a centre-piece for modernisation and decarbonisation of CEE economies[3].

Figure 3: What is the Modernisation Fund value at a €30/tonne ETS price if it were maximised?



What have countries decided? The environment ministry of the Czechia has said they would use them for Article 10d Modernisation Fund (as per our recommendation)[4]. Poland is also considering not using the 10c, although hasn't decided whether they would auction them or transfer them into the Modernisation Fund[5]. Perhaps Poland is waiting for clarification on the MSR recalculation? Either way, we recommend Poland to transfer both Article 10c and Solidarity Provision to maximise the Modernisation Fund.

It is essential that the next decade is one focused on the modernising of the energy sector, beyond the use of carbon-intensive forms of energy. Maximising use of the Modernisation Fund would help achieve just that.

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[3] Note: The "Basic" modernisation fund includes the assumption of 57% auction share is used for 2021-2025 and 52% for 2026-2030, which means an addition 65.5 million allowances available to the Modernisation Fund.
[4] See https://twitter.com/EwaBN/status/1131922093015224322
[5] https://www.bloomberg.com/news/articles/2019-06-06/poland-may-halt-free-co2-permits-for-utilities-to-boost-budget

About this briefing

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About Sandbag

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

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

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