



# CAN EUROPE'S POSITION ON THE POST-2020 ETS REFORM

December 2016

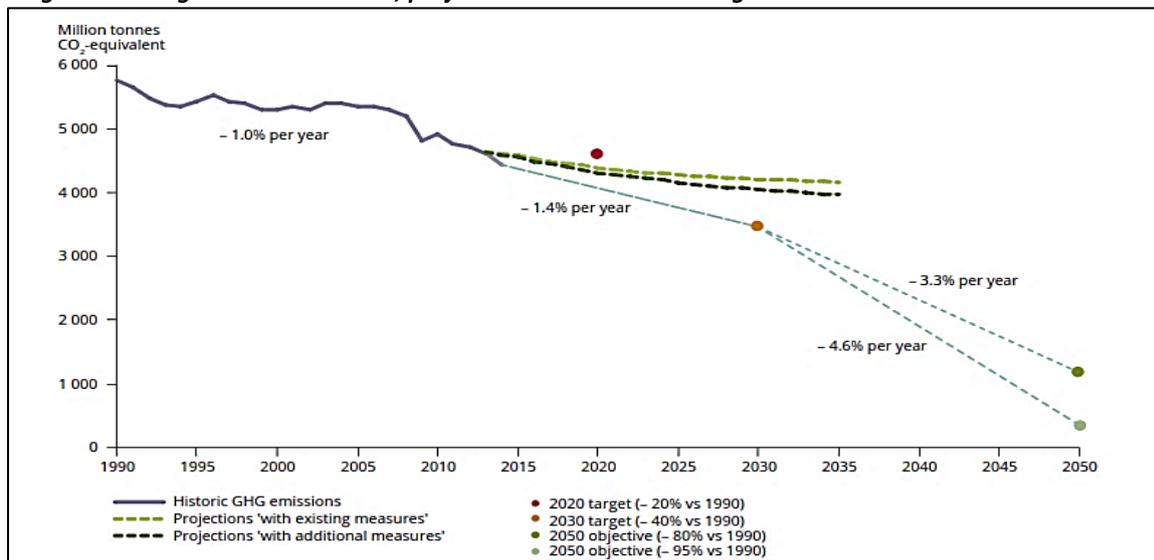
*Climate Action Network (CAN) Europe is Europe's largest coalition working on climate and energy issues. With over 130 member organisations in more than 30 European countries - representing over 44 million citizens - CAN Europe works to prevent dangerous climate change and promote sustainable climate and energy policy in Europe.*

## PARIS IS A CALL FOR ACTION!

In the Paris Agreement all countries agreed to hold the temperature increase well below 2°C and furthermore to pursue efforts to limit it to 1.5°C. But the emission reduction contributions that countries have agreed to still leave us with emissions that lead to 3°C warming. If the European Union wants to walk its talk, it must act now to ensure that the Paris deal results in real additional action.

**Climate action in Europe before and after 2020 needs to be substantially increased if we are to achieve the goals that governments agreed to in Paris.** Governments agreed in Paris to come together to take stock of the collective efforts in 2018, and resubmit potentially improved targets latest by 2020. In order to remain true to its commitments, the EU needs to revise its greenhouse gas emission reduction targets for 2020 and for 2030.

### EU greenhouse gas emission trends, projections and reduction targets<sup>1</sup>



<sup>1</sup> <http://www.eea.europa.eu/publications/trends-and-projections-in-europe-2015>

Currently the EU's goal is to reduce its greenhouse gas emissions by 80-95% by 2050, with the current 2030 climate targets on a trajectory to meet 80% domestic emission reductions only and most of those reductions postponed until after 2030, see graph. According to recent research, Europe would have to reduce its emissions more than 95% below 1990 levels by 2050 to ensure a more than 50% chance to have no more than 1.5°C warming by 2100.<sup>2</sup>

In stark contrast, the current 2030 Emissions Trading Scheme (ETS) target of 43% below 2005 emission levels would only lead to an 84% reduction in the ETS sectors by 2050. **Only emissions reductions of at least 95% or higher by 2050 can ensure some chances of staying below 1.5°C warming. This requires faster and significantly more reductions in the ETS.**

## THE ETS IS FAILING TO DELIVER

The ETS aims to help the EU achieve its long-term greenhouse gas reduction goals more cost-effectively and is meant to encourage investments in low-carbon technologies. Despite being hailed as the flagship of European climate policy, the ETS has failed to deliver on these objectives, mainly due to intensive lobbying of a small number of energy-intensive industry federation lobby groups.

A weak reduction target, the massive use of international offsets, and inflexible policy design have led – together with the economic recession – to an enormous oversupply of pollution permits. The price for these permits (called emission allowances) has therefore dropped so much that it no longer drives change to a low carbon economy.

The Market Stability Reserve (MSR) is an important but insufficient first step to improve the ETS. The surplus is only temporarily removed and models predict that the market will be oversupplied until 2025 or later.

Europe is currently discussing how it should revise its ETS for the post 2020 period. In July 2015, the European Commission published its proposal on the revision.<sup>3</sup>

Absent reforms that go well beyond what the European Commission is proposing, companies can delay or cancel investments in cleaner and more efficient production. The sectors that cause almost half of Europe's greenhouse gas emissions could continue polluting at business-as-usual levels for the next 10 years or longer. This risks a lock-in of carbon intensive infrastructure for years to come, making Europe's climate goal more time-consuming and costly to achieve.

Absent meaningful ETS reforms, fragmentation of climate policy may increase as it would be then in the hands of national governments to implement national policies and measures to tackle climate change effectively.

Last but not least, even if the reforms were to be bold and swift we will need other strong policies, such as for renewable energy and energy efficiency, and binding bioenergy sustainability criteria that accurately account for emissions from biomass.

The ETS can at best support achieving the necessary long-term decarbonisation. A price signal is important. But a price signal alone, even if it was considerably higher, will not be sufficient to facilitate transformational change.

It is important that policy makers take into consideration research-based facts. Disproportionate receptiveness to intensive lobbying of a small number of energy-intensive industry lobby groups could hold back effective reform. The following chapters lay out detailed reform proposals.

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<sup>2</sup> Joeri Rogel's preliminary modeling results. He is based at IIASA.

<sup>3</sup> [http://ec.europa.eu/clima/policies/ets/revision/documentation\\_en.htm](http://ec.europa.eu/clima/policies/ets/revision/documentation_en.htm)

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# 1. MAKING THE ETS FIT FOR PURPOSE

Currently the EU's goal is to reduce its greenhouse gas emissions by 80-95% by 2050, with the current 2030 climate targets on a trajectory to meet 80% domestic emission reductions only and most of those reductions postponed until after 2030. According to recent research, Europe would have to reduce its emissions more than 95% below 1990 levels by 2050 to ensure a more than 50% chance to have no more than 1.5°C warming by 2100.<sup>4</sup>

In stark contrast, the current 2030 ETS target of 43% below 2005 emission levels would only lead to a 84% reduction in the ETS sectors by 2050. The weak current target is especially troubling because the EU is actually reducing its emissions far faster than its reduction targets. Recent modelling shows that by 2020, Europe is on track for a 30% cut in economy-wide emissions relative to 1990. In the ETS sectors, emissions will be down 38% against the ETS's 2005 baseline by 2020.<sup>5</sup>

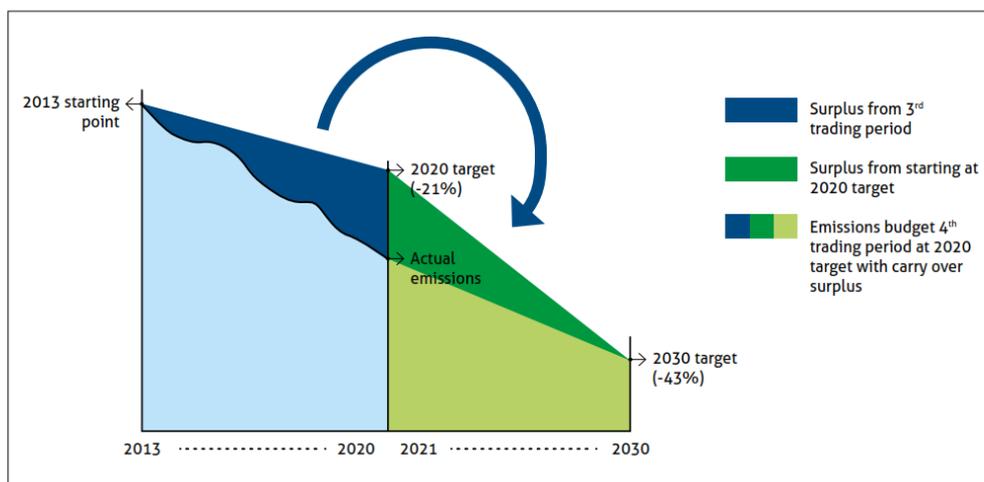
In addition to establishing a meaningful ETS price signal a broad set of policy measures and instruments will be needed in order to guide the transition to a 100% renewable energy future.

## 1.1 STARTING POINT FOR 2021 SHOULD BE AT ACTUAL EMISSION LEVELS

The starting point for 2021 should be at actual emissions and not at the current minus 21% ETS target for 2020. If the emissions will be, as projected, at minus 38% in the ETS sectors by 2020, starting at actual emission levels would significantly reduce total emissions under the ETS. We propose that the starting point should be based on average emissions from 2017-2019. This would eliminate between 316 to 2,398 million tonnes of surplus compared to the Commission's proposal, depending on where actual emissions will be in 2017-2019 (see dark green triangle in figure below).<sup>6</sup>

Please note that this measure would not eliminate the surplus from phase 3, it would therefore be most effective to combine this measure with surplus cancellation, see figure below.

FIGURE 2: Phase 4 ETS emissions budget including carry over and 2020 target starting level



## CAN EUROPE CALLS FOR

<sup>4</sup> Joeri Rogel's preliminary modeling results. He is based at IIASA.

<sup>5</sup> [https://sandbag.org.uk/site\\_media/pdfs/reports/EU\\_on\\_track\\_for\\_30\\_cuts\\_by\\_2020\\_9Dec15.pdf](https://sandbag.org.uk/site_media/pdfs/reports/EU_on_track_for_30_cuts_by_2020_9Dec15.pdf)

<sup>6</sup> SEE: [CAN EUROPE BRIEFING: A FRESH START FOR THE ETS](#)

- **The starting point for 2021 to be set at average 2017-2019 emissions and not at the ETS target for 2020 (21% below 2005 emissions).**

## **1.2 PERMANENT CANCELLATION OF ALLOWANCES**

As mentioned above, by 2020 ETS emissions are projected to be down 38% against the ETS's 2005 baseline, whereas the current ETS target only requires reductions of 21%.<sup>7</sup> This is why by 2020, the ETS surplus will have grown to between 2.6 and 4.4 billion allowances.<sup>8</sup> Permanent cancellation of this surplus can be used to bring Europe back onto the least-cost path towards its climate goals.<sup>9</sup> The billions of surplus pollution permits that will have accumulated by 2020 can, under current rules, be fully carried over to the next trading period. This huge carry-over significantly increases the total volume of greenhouse gases that can be emitted until 2030 and beyond.

To address the oversupply and create a more stable price, EU policy makers agreed in 2015 to establish a Market Stability Reserve (MSR). It will start in 2019 and will temporarily withhold part of the surplus from the market and will bring it back when available allowances go below a certain level. Although a welcome policy tool, it is unclear how effective the MSR will be in practice. What is worse, the MSR does not permanently remove any of the surplus.

The Commission's proposal for an ETS reform does not include any provisions on the cancellation of surplus. Such provisions should be included in the revision. The permanent cancellation of surplus helps ensure that the EU's 2030 climate target is met by actual emission reductions rather than with left-over surplus.

### **CAN EUROPE CALLS FOR THE FOLLOWING MEASURES WHICH SHOULD BE COMBINED WITH EACH OTHER:**

- **The permanent cancellation at the end of 2020 of around two billion surplus allowances that will have accumulated in the MSR by that point.**
- **A limit on the number of allowances than can be stored in the Market Stability Reserve (MSR).** To avoid a large accumulation of allowances in the MSR should hold a maximum of allowances equal to 50% of the total ETS allowances made available in a given year. Allowances in the MSR above this ceiling should be automatically cancelled.<sup>10</sup>
- **A limit on the validity of allowances in the MSR.** Allowances that remain in the MSR for more than five years should be cancelled permanently. This provision would also ensure that the MSR does not grow to be very large.
- **Allowing the unilateral cancellation of allowances by Member States.** If individual Member States choose a higher mitigation target or other measures that raise their mitigation levels, they should be able to cancel allowances that would enable them to unilaterally raise the stringency of their target without just making it easier for other Member States to reach the overall EU target<sup>11</sup>.

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<sup>7</sup> [https://sandbag.org.uk/site\\_media/pdfs/reports/EU\\_on\\_track\\_for\\_30\\_cuts\\_by\\_2020\\_9Dec15.pdf](https://sandbag.org.uk/site_media/pdfs/reports/EU_on_track_for_30_cuts_by_2020_9Dec15.pdf)

<sup>8</sup> EC (2014), SWD(2014)17, Impact Assessment accompanying the Proposal for a Decision concerning the establishment of a market stability reserve (see <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014SC0017&from=EN>) UK government: 3.1 billion, (see [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/364992/UK\\_MSR\\_position\\_gov.uk.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364992/UK_MSR_position_gov.uk.pdf)); estimates by Sandbag: 4.4 billion, (see [https://sandbag.org.uk/site\\_media/pdfs/reports/EU\\_on\\_track\\_for\\_30\\_cuts\\_by\\_2020\\_9Dec15.pdf](https://sandbag.org.uk/site_media/pdfs/reports/EU_on_track_for_30_cuts_by_2020_9Dec15.pdf))

<sup>9</sup> COM (2011): A Roadmap for moving to a competitive low carbon economy in 2050: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52011DC0112>

<sup>10</sup> This would lead to a gradual decrease in the maximum allowances that can be stored in the MSR equal to the linear reduction factor and therefore take into account that as companies start to decarbonize to meet their 2030 target there will need fewer allowances. With a LRF of 2.2% the maximum allowances that can be stored in the MSR would be about 900 million in 2021 and about 700 million in 2030.

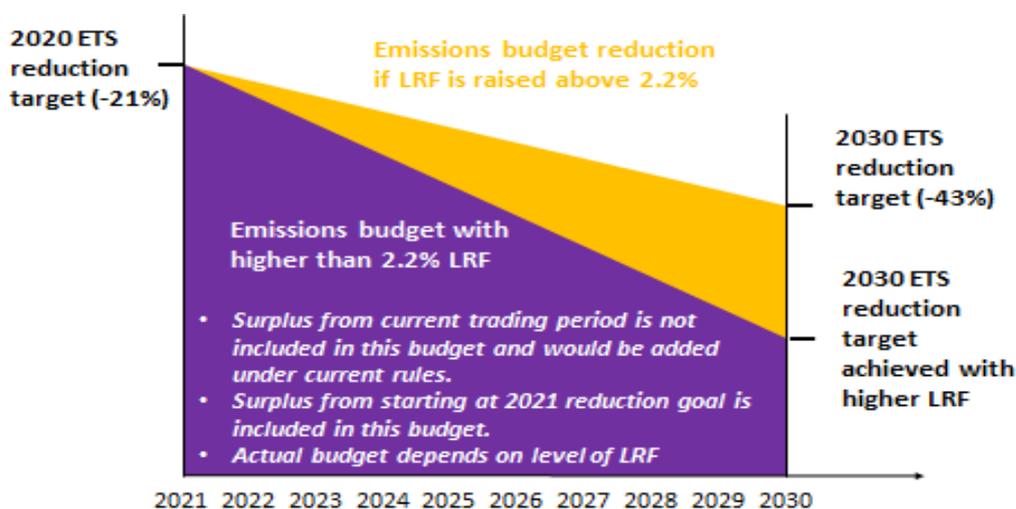
<sup>11</sup> As provided for in Art 193 of the EU Treaty: "protective measures [on Environment] shall not prevent any Member State from maintaining or introducing more stringent protective measures."

- **Allowances that remain in the new entrants reserve at the end of each trading period should be cancelled.** A second best option would be to put them into the MSR. The phase 4 new entrants reserve should therefore only be filled with allowances from phase 4.

### 1.3 RAISING THE LINEAR REDUCTION FACTOR

Ensuring the starting point in 2021 is at actual emissions levels and the permanent cancellation of surplus allowances are the best way to ensure the ETS is made fit for purpose as quickly as possible. Raising the linear reduction factor has a slower but longer term effect and is also an important option, especially in combination with the first two, to ensure the ETS is turned into a functioning mitigation instrument. The Linear Reduction Factor (LRF) determines by how much the number of available allowances are reduced every year. The proposed LRF of 2.2% (see Article 9) for the period from 2021 to 2030 is too low according to the Commission’s own Impact Assessment from 2014. It would lead to ETS reductions by 2050 of only 84% compared to 2005. The Impact Assessment notes: *A 90% reduction was the average reduction projected for the Roadmap for moving towards a competitive low carbon economy in 2050. In order to set the cap equal to this level in 2050 the linear reduction factor in the ETS would need to further increase to -2.4% until 2050.*<sup>12</sup>

#### **Illustrative graph to show effect of raising Linear Reduction Factor**



#### **CAN EUROPE CALLS FOR**

- **A Linear Reduction Factor which leads to a cost effective greenhouse gas reduction of at least 95% until 2050.** The linear reduction factor (LRF) should be raised well above the 2.2% currently suggested. A sharper increase of the LRF will be crucial to the further credibility of the system as it sends a long-term signal for the decarbonisation of the economy.

### 1.4 RAISE TARGET EVERY FIVE YEARS

The Paris Agreement includes the requirement for all countries to come up with contributions to reduce emissions every five years. Accordingly, the ETS trading periods should also be five years. The current proposal is to have a ten-year trading period. This is longer than any ETS trading periods so far. Such a long trading period can lead to inflexibilities and make it difficult to improve the ETS during that period.

#### **CAN EUROPE CALLS FOR**

<sup>12</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014SC0015&from=EN>, footnote 122

- **Increasing ETS targets every five years.** ETS trading periods should also be five years. The ETS Directive should in any case include a revision clause that requires the European Commission to upwardly increase the ETS target every five years until the ETS is in line with a linear pathway that will ensure the EU lives up to its commitments under the Paris agreement, including to pursue to keep temperature rise below 1.5°C.

## **1.5 PRESERVING THE DOMESTIC OVERALL EU TARGET: NO USE OF INTERNATIONAL OFFSETS, ETS LINKING ONLY UNDER CERTAIN CONDITIONS**

As the European Council Conclusions of October 2014 specified that the at least 40% overall emissions reduction target is a domestic one, it implicitly excludes the use of carbon market units (offsets and allowances) to meet that target. Nevertheless some Member States have been calling for the use of international offsets if the overall EU target is raised or if Member States chose unilaterally to take a higher target.

Also some are interpreting the Council Conclusions as applying only to offsets but not to the linking to other emissions trading schemes outside the EU. Linking to another emissions trading scheme will have different outcomes<sup>13</sup> on the EU's overall domestic target. If the EU would be a net seller of allowances, more mitigation would occur within the ETS and in turn less mitigation would occur in the other emissions trading scheme. So, the EU would still ensure that its domestic emissions are in line with the domestic target. This would be different if the EU was a net buyer. In that case the EU's overall target would no longer be domestic. In order to ensure that the target stays domestic in this case, the ETS target would have to be raised proportional to the number of outside allowances that would be purchased. But it would be difficult to determine how much the target would need to be increased, as one would not know in advance how many net transfers will take place.

Linking the ETS to emissions trading schemes in foreign jurisdictions can have profound implications for Europe's climate standards. ETS linking to a emissions trading scheme with lower standards can reduce overall domestic emissions abatement, lower domestic investments and co-benefits and lead to a loss of public funds<sup>14</sup> while making it more difficult to uphold the democratic control over domestic climate policies. Linking could also undermine the functioning of the Market Stability Reserve and see the EU lose control over carbon offsets, as offsets available in linked emissions trading scheme would indirectly be eligible in the ETS.<sup>15</sup>

### **CAN EUROPE CALLS FOR**

- **International offsets not to be used for the ETS target.** International offsets have discouraged European industries from investing in lowering emissions in their own installations and contributed to windfall profits for certain industries. The quality of Clean Development Mechanism and Joint Implementation offsets have shown to be low.<sup>16</sup> The use of low quality offsets leads to a rise in global emissions. In addition, it is still very unclear what offsets would be available post-2020 and if accounting rules will be sufficient to avoid double counting – a situation where the emissions reductions from an

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<sup>13</sup> <https://icapcarbonaction.com/component/attach/?task=download&id=279>

<sup>14</sup> Reduced auctioning revenues

<sup>15</sup> An installation under the linked system could buy offsets to meet its obligations and in turn sell its spare allowances to an installation in the EU ETS.

<sup>16</sup> See for example [CDM Impact assessment](#) which estimates that under realistic assumption (see box 1 on p.77 “pessimistic scenario”) for each CDM offset (which entitles the buyer to emit one tonne more) only 0.38 tonnes of emissions were actually reduced. For Joint Implementation [recent research findings](#) are even more extreme: for each JI offset on average only 0.25 tonnes or less were reduced. Given that these shortcomings have been known to policy makers for years but have not been addressed and given that under a new climate agreement rules will very likely be considerably more lax, it would be completely unrealistic to assume that the environmental integrity of offsets will increase post-2020. Also, even though the EU has passed quality restrictions on international offsets used under the ETS, they have not prevented the EU's ETS target to be undermined by at least 400 million tons for the period from 2008-2012 alone, see [here](#).

offset are counted both by the buyer and the seller country). In order to protect the integrity of European mitigation targets, international offsets should not be eligible for compliance.

- **Any linking would need to ensure that the EU's domestic target will still be met.** If the EU links to other ETSs, it could become a net buyer or net seller of units, depending on the ambition of the target and abatement costs in both schemes. If the EU would become a net buyer, it would no longer meet its domestic target. This could be addressed by e.g. only allowing one-way linking (only allowing transfers of EU allowances from the EU to abroad but not vice versa) or raising the ambition of the ETS target **and** putting a quantitative limit on the amount of units that can be imported in the EU to ensure that the domestic target is still met.
- **Any ETS linking should not compromise the integrity of the EU's climate ambition.** To avoid this, the ETS should only be linked to carbon markets that do not allow for international offsets or domestic offsets with questionable benefits (such as temporary removal credits from forestry), that have an equivalent price and supply management and a robust allowance allocation method and cover similar sectors as the ETS.
- **The introduction of public review of linking proposals.** Given the far reaching implications on the integrity of climate policy in the respective jurisdictions, the upcoming proposal to revise the ETS should strengthen the democratic process surrounding the linking negotiations. It should improve transparency about negotiation meetings and provide public access to the linking negotiation mandate and other relevant documents. It should also improve public participation, for example by holding a public consultation before the linking negotiations start and by organizing stakeholder meetings during the negotiations rounds. It should furthermore strengthen the role of the European Parliament.

## 2. ENSURING RAPID MITIGATION ACTION

The higher the carbon price the more incentive companies have to implement low carbon strategies. If the carbon price rises sooner, companies will act sooner, even if there is no change in the overall ambition (e.g. if the 2030 targets remain the same). Earlier action can prevent lock-in of carbon intensive installations and technologies. Ensuring companies act rather sooner than later is also necessary to ensure a functioning ETS. Therefore, the carbon price signal should increase in the short term in order to avoid price volatility on the market later on. There are several ways to do so:

### 2.1 UNUSED ALLOWANCES SHOULD NOT BE USED FOR NEW ENTRANTS

According the European Commission ETS reform proposal, 395 mio unused allowances from Phase 3 (2013-2020) would be available for the New Entrants (new or expanded industrial facilities that get such allowances for free) after 2020 (Phase 4). This will increase the supply of allowances available to the market and lower the EU carbon price, undermining the purpose of the Market Stability Reserve immediately after it becomes operational.

#### **CAN EUROPE CALLS FOR**

- **All unallocated allowances from Phase 3 to be cancelled permanently.** This will ensure that unused surplus pollution permits from the third trading phase don't undermine post-2020 emission reductions. A second best option would be to ensure all unallocated allowances are placed and kept in the MSR rather than being reassigned to the Phase 4 NER.

- **Phase 4 allowances should be held aside for New Entrants after 2020.** Instead of using unallocated Phase 3 allowances for the New Entrants Reserve, 400 million allowances should be set aside from the Phase 4 free allowances cap for this purpose.

## **2.2 ALLOWING ALTERNATIVE POLICIES AND MEASURES AT NATIONAL LEVEL**

CAN Europe calls for more action at Member States level to fill the gap left behind by the shortcomings of the proposed ETS reform. The ETS in its current form is an obstacle to more ambitious climate goals some Member States may want to take. Alternative national policies and measures can ensure that climate action is not postponed and lock-in into high emitting infrastructure is avoided.

One example of such a measure is a CO<sub>2</sub> floor price, which, if high enough, would ensure that action is not postponed. Another idea is the establishment of an Emission Performance Standard (EPS) setting an efficiency standard for specific installations (eg. max. 500gCO<sub>2</sub>/kWh for the power sector) in order to avoid lock-in of high emitting infrastructure. CAN Europe would very much welcome such national measures to speed up mitigation action.

### **CAN EUROPE CALLS FOR**

- **Member States to introduce alternative policies such as a carbon price, a carbon tax, or an Emission Performance Standards to apply for installations covered by the ETS.** This should be complemented by allowing for the cancellation of allowances by individual Member States to ensure additional national mitigation action in progressive Member States does not simply make it easier (by lowering the carbon price) for Member States that are lagging behind.
- **Member States to support climate action and innovation beyond the dedicated modernization and innovation funds set aside in the ETS, using revenues from auctioned allowances or other forms of taxation for this purpose.**

## **2.3 MAXIMIZE AUCTIONING OF ALLOWANCES**

If companies have to purchase all their allowances, emitting greenhouse gas becomes more expensive and cleaner production becomes more cost-effective. This is one of the reasons why CAN Europe is in favour of rapidly moving to 100% auctioning of allowances (see next section). An increase in ETS auction revenues will allow national treasuries to increase funding for climate action programmes at home and abroad.

## **3. INDUSTRY HANDOUTS AND WINDFALL PROFITS HAVE TO STOP**

188 countries have submitted their climate commitments (INDCs), accounting for over 95 percent of global emissions. The argument that the EU is acting alone on climate is certainly no longer valid, and more and more countries globally are establishing climate and energy policies that cover similar sectors as captured by the ETS.

The success of the ETS revision hinges on its ability to make the polluter pay, rather than paying the polluter. Handing out free pollution permits contradicts the EU Treaty principle that polluters should pay. Generous exemptions in the form of free pollution permits have led to windfall profits for large energy intensive companies on the backs of EU citizens. Since the year 2013, power companies buy all of their emission allowances at auction. However, manufacturing industries that have been deemed at risk of carbon leakage continue to receive up to 100% of their CO<sub>2</sub> allowances for free.

Auctioning is the most cost-efficient, simplest, fairest, and most transparent way to allocate allowances, fully reflecting the polluter-pays principle. Increasing the share of auctioning can support larger investments in the tools needed for further decarbonisation and climate resilience, in the EU and internationally.

Existing provisions to protect the manufacturing industry in Europe against the potential risk of relocation due to the ETS apply for the period from 2013 to 2020. Currently, more than 150 sectors, representing more than 97% of industrial emissions, are deemed to be at risk of “carbon leakage” and receive free pollution permits. Between 2013 and 2020, in total 6.6 billion allowances will be given out for free to industry with a monetary value of € 50 billion<sup>17</sup>.

A key question is how the concept of “carbon leakage” will be addressed in the next ETS trading round from 2021-2030. The European Commission proposal for the ETS revision proposes to continue many of the existing rules, including the hand-out of around 6.3 billion free pollution permits in the post-2020 period. The European Commission anticipates that the carbon price will increase from around €8 today to an average €25 in the 2021-2030 period, which would represent an indirect financial subsidy of €160 billion<sup>18</sup> to large polluters.

CAN Europe is against such blanket pollution subsidies and supports a move to 100% auctioning. We are calling for fairer and stricter rules which would ensure that free pollution permits are significantly limited through a tiered and focused system. Free pollution permits should not be given to industries that do not face significant and proven competitiveness risks.

**Carbon leakage** is a term used to describe the hypothetical situation where stringent climate policies would force companies to move their production abroad to countries with less ambitious climate measures to lower their production costs. This can theoretically lead to a rise in global greenhouse gas emissions.

***What evidence is there for “carbon leakage”?***

There has so far been no compelling evidence that EU’s climate policies are forcing companies to move abroad. A study commissioned by the European Commission concluded in 2013 for example that no conclusive evidence of carbon leakage occurrences can be detected<sup>19</sup>.

Relocation of European industry due to the ETS is also unlikely to happen in the future: A recent academic paper finds that the future impact of more ambitious climate policies on EU companies moving their production abroad is likely to be “extremely limited”. A ten-fold increase in the carbon price would cause exports to fall by only 0.5% and would increase imports by 0.07%, even assuming a complete phase-out of free pollution permits (100% auctioning).<sup>20</sup>

Some industry groups have been arguing that there is a risk of “investment leakage”: new investments going outside of Europe. However, investment decisions are made based on a broad set of factors in globally competing industries, where the EU carbon price signal is a negligible factor. Given the surplus projections this is unlikely to change in the next trading phase. As with carbon leakage, there is no evidence for such investment leakage due to the ETS. The best way to support industries to fully decarbonize and to stay in Europe is to auction more allowances and invest the revenues in the European economy. Free allocation does little to tackle investment leakage as it is uncertain whether the companies invest the resulting profits in Europe, or somewhere else (or just give the profits to their shareholders). Moreover, investment leakage might not even lead to a rise in global greenhouse gas emissions, if the investments are done in more efficient plants than those in Europe. This is by no means just rhetoric, as India and China have particularly efficient cement production for example (more efficient than the European and global average)<sup>21</sup>.

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<sup>17</sup> SWD(2015) 135, Impact Assessment accompanying the EU ETS revision see [here](#), p. 29

<sup>18</sup> SWD(2015) 135, Impact Assessment accompanying the EU ETS revision see [here](#), p. 27

<sup>19</sup> See Ecorys’ Carbon Leakage Evidence Project: Factsheets for selected sectors, September 2013

<sup>20</sup> London School of Economics (2015), Asymmetric industrial energy prices and international trade, see [here](#)

<sup>21</sup> Climate Strategies (2014), Staying with the Leaders: Europe’s Path to a Successful Low-Carbon Economy, see: [here](#)

### **3.1 PHASE OUT FREE POLLUTION PERMITS AND MOVE TO 100% AUCTIONING**

The EU leaders have decided in October 2014 that the current share of total ETS allowances that are auctioned by Member States must not be reduced after 2020. According to the Commission's analysis at least 57% of the total allowances are currently auctioned by Member States. However, the Commission's proposal sets the share of allowances to be auctioned by Member States at only 55%, as it proposes that 2% should go to the Modernisation Fund. The Modernisation Fund does not directly benefit public budgets, because it channels finance directly to energy projects. That means that the 2% of total allowances set-aside for this fund should be in addition to the 57% of allowances that are distributed to Member States.

#### **CAN EUROPE CALLS FOR**

- **The phase out of handing out free pollution permits** to avoid subsidies for carbon pollution in the order of €160 billion in the 2021-2030 period.
- **The share of emission allowances to be auctioned by Member States should be at least 57% and increase over time to 100%.** The 2% of total allowances set-aside for the Modernisation Fund should come on top of the 57% auctioning share.

### **3.2 AVOIDING WINDFALL PROFITS**

Some energy-intensive corporations have used the ETS to increase their cash flow, using the theoretical risk of carbon leakage as an argument to receive pollution subsidies from governments. These companies have profited from the ETS in the following ways:

- 1. Industries have generated windfall profits by letting their customers pay the price for freely obtained carbon permits.**

Several carbon-intensive industries that are not at genuine risk of carbon leakage are still receiving all of their allowances for free. These corporations are able to cash in these freely obtained allowances by passing on the costs for these allowances to their customers even though they did not have to pay for them.

Numerous studies including an analysis by the European Commission have found that companies pass through at least part of the costs of carbon pricing to consumers, see table below. This means that they have to bear only the remaining part of the costs (i.e. the costs not passed through to customers). The steel and refineries sectors for example pass through 60%-100% of the market price of carbon to their consumers. For manufacturers as a whole, this may have resulted in possible windfall profits in the order of €25 billion, assuming an average 50% cost-pass through rate.<sup>22</sup>

The European Commission therefore underlines that "all sectors analysed would be expected to gain windfall profits" in the post-2020 period based on the current ETS revision<sup>23</sup>. In the steel sector alone for example, the proposed ETS revision will lead to at least €13 billion windfall profits, according to the Commission's own analysis<sup>24</sup>. This stands in contrast to the EU Council Conclusions of October 2014 stressing that the consideration to "avoid windfall profits will be taken into account".

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<sup>22</sup> Own calculation for the 2013-2020 period, assuming 6.6 billion free emission allowances that are sold at today's prices (±€8/tCO<sub>2</sub>). The 50% cost-pass through rate is an estimate based on table 33 of SWD(2015) 135

<sup>23</sup> SWD (2015) 135, Impact Assessment accompanying the EU ETS revision see [here](#), p. 182 (using the highest cost-pass through rates found in literature)

<sup>24</sup> SWD (2015) 135, Impact Assessment accompanying the EU ETS revision see [here](#), p. 183 table 24 (using the lowest cost-pass through rates from the literature), €1.3 billion/year or €13 billion in the 2021-2030 period)

See also section 3.5 on indirect costs.

TABLE 1: OVERVIEW OF THE RANGE OF AVERAGE COST PASS-THROUGH IN SELECTED SECTORS FROM LITERATURE <sup>25</sup>

| Sector                | Product                           | Minimum | Maximum | # of studies | Estimated in  |
|-----------------------|-----------------------------------|---------|---------|--------------|---|
| Iron and steel sector | Flat products                     | 60%     | 100%    | 3            | McKinsey(2006); Vivid Economics (2014); CE Delft (2010)   |
|                       | Long products                     | 66%     | 80%     | 2            | McKinsey(2006); Vivid Economics (2014)  |
| Cement                | Portland cement, white cement     | 35%     | 70%     | 4            | McKinsey (2006); Vivid Economics (2014); Walker (2008); Alexeevi-Talebi (2010)                      |
| Glass                 | Container glass                   | 20%     | 50%     | 2            | Vivid Economics (2014); Oberndorfer (2010)  |
|                       | Hollow and other glass            | 30%     | 80%     | 3            | Vivid Economics (2014); Oberndorfer (2010); Alexeevi-Talebi (2010)                                  |
| Refineries            | Petrol                            | 60%     | 120%    | 5            | McKinsey(2006); Vivid Economics (2014); CE Delft (2010); Alexeevi-Talebi (2011); Oberndorfer (2010) |
|                       | Diesel                            | 40%     | 70%     | 4            | McKinsey (2006); Vivid Economics (2014); CE Delft (2010); Oberndorfer (2010)                        |
| Petrochemicals        | Plastics, PE, PVC, PS             | 25%     | 80%     | 3            | CE Delft (2010); Alexeevi-Talebi (2010); Oberndorfer (2010)   |
| Fertilizers           | Fertilizer and nitrogen compounds | 0%      | 75%     | 2            | Alexeevi-Talebi (2010); Oberndorfer (2010)  |

**2. Industries have received more allowances for free than they actually needed, and are able to sell their over-allocation for an additional windfall profit in the market.**

Carbon-intensive industries have in the past received more free allowances than they actually needed, and are able to sell off the surplus allowances for a profit in the market. The European Commission found that during 2005-2013, industrial sectors accumulated a surplus of around one billion allowances they received for free. If surplus is sold on the market against average annual prices, these industries are able to generate a windfall profit of €11 billion.<sup>26</sup>

The surplus of free allowances is partly the result of flawed partial cessation rules in the ETS Directive. Companies continue to receive free emission allowances based on historical production levels even if their production levels have gone down by almost half. This means that industries that run their factories at lower production levels can use this loophole to receive up to twice as many emission allowances for free than they actually need. They can then sell these surplus allowances which has led to the perverse situation in which some industrial factories tried to maximize their windfall profits by reducing production levels and cashing in the resulting surplus allowances.

**CAN EUROPE CALLS FOR**

- **Sectors on the carbon leakage list should not be eligible to receive free allowances for the share of carbon costs that are passed on to customers.** This helps to avoid windfall profits by ensuring that sectors are not compensated for the carbon costs that they can pass on to their customers. This means in practice that the formula to determine the amount of free allowances for a company is adjusted to:

<sup>25</sup> SWD(2015) 135, Impact Assessment accompanying the EU ETS revision see [here](#), p. 202 table 33

<sup>26</sup> Sandbag: Estimate for accumulated EUAs including offsets surrendered until 2012: 1.17 billion. The net worth is estimated to be €11.27 billion and is based on yearly averages for EUAs and offset prices.

*historic production level \* benchmark value \* percentage free allocation \* correction factor \* (100% – cost-pass through rate)*

- **Companies that decrease their production should see an equivalent reduction in their allocation of free allowances, in order to avoid windfall profits from selling surplus allowances.** The decrease in allowances should take effect if the decrease in production is 10-15% or more in any given year. If there is an increase in production, the share of free allocations should not decrease the overall share of auctioned allowances. Government authorities should furthermore be allowed to reclaim unused free allowances per month from companies that have closed production<sup>27</sup>.

### **3.3 BENCHMARKS**

The amount of free allowances that an installation receives is determined by performance benchmarks. The current benchmark values are determined based on performance data of the 10% most efficient installations in the EU in each sector based on their production in the years 2007 and 2008. If these benchmarks remained the same they would be severely outdated as the data would be more than two decades old by 2030. The European Commission has therefore proposed to update these performance benchmarks to reflect the progress in technological developments since 2007-2008. The European Commission suggests to reduce benchmark values on average from 2007-2008 by 15% for the 2021-2025 period and by 20% for the 2026-2030 period to reflect technical progress since then (= average 1% annual improvement rate). If on the basis of actual submitted production data the annual progress is much higher or lower than 1%, the benchmark values are annually reduced by 0.5% or 1.5% instead.

#### **CAN EUROPE CALLS FOR**

- **Base the benchmark values on the 10% best performers globally (in terms of greenhouse gas emission performance) on the global market, similar to the Japanese top-runner approach in consumer products.** <sup>28</sup> This ensures that European installations receive an incentive to keep up with their global competitors. Only installations which reach or exceed the globally determined benchmark should be able to receive a maximum of 100% free allowances. This provides an incentive for the best global performers in each manufacturing sector to set up shop in Europe, while encouraging the dirtier installations to lower their emissions. In addition, accurate performance benchmarks will reduce the need for a downward adjustment of the overall amount of free allocations through the application of the cross sectoral correction factor.
- **As a second best option, annually adjust the benchmarks by the same percentage as the reduction of the overall ETS cap (e.g. the linear reduction factor).** The adjustments to the product benchmarks should follow the overall reduction pathway of the ETS sectors to keep the incentive of decarbonisation in line with the overall cap. If on the basis of the submitted production data it is shown that sectors have annually reduced their emissions intensity by more than 0.5% above or below the linear reduction factor, then the benchmark values shall be annually adjusted by an additional -0.5% or +0.5% on top of the linear reduction factor.

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<sup>27</sup> See the [Benchmarking Decision](#), Art. 22(3), “Where an installation has ceased operation, the Member State concerned shall not issue emission allowances to this installation as of the year following the cessation of operations”, e.g. under current rules, if an installation ceases operation on 1 January of a certain year it would still be eligible for free allowances for that whole calendar year.

<sup>28</sup> Japanese manufacturers, including importers, are obligated to meet continuously updated energy efficiency targets in 30 different product categories. See the IEA’s description of the programme here: <http://www.iea.org/policiesandmeasures/pams/japan/name-21573-en.php>.

### 3.4 LIMIT THE HAND-OUT OF FREE POLLUTION PERMITS TO THOSE REALLY AT RISK

The ETS revision presented in July 2015 proposes to make free emission allowances available to all industrial sectors, whether they are at risk of delocalizing or not. The exposure to “carbon leakage” is determined by the multiplication of the trade and the emissions intensity of an industrial sector, see box for details.

#### **The Commission’s proposed formula to determine the amount of free pollution permits**

Industrial sectors are given free emission allowances to protect them from EU’s carbon pricing instrument in order to address the hypothetical risk of “carbon leakage”.

The formula to determine the amount of free allocation for a certain company (both in the current situation as well as under the newly proposed rules) is:

**Free allowances =**

***historic production level \* benchmark value \* percentage free allocation \* correction factor***

#### **BENCHMARK VALUE**

The amount of free allowances that an installation receives is determined mainly by performance benchmarks. The current benchmark values are determined based on performance data of the 10% most efficient installations in the EU in each sector based on their production in the years 2007 and 2008.

#### **PERCENTAGE OF FREE ALLOCATION**

Industrial sectors that are deemed to be exposed to the risk of carbon leakage are put on the so-called “carbon leakage list” and receive 100% of their allowances up to the benchmark for free. Two parameters are assessed in order to determine the exposure of each industrial sector to the risk of “carbon leakage”: their trade intensity (imports and exports) and their emissions intensity. The other industrial sectors not on the list receive 30% for free. Only 6% of industry’s emissions will not receive 100% free allocation of their emission allowances.

#### **CORRECTION FACTOR**

The maximum amount of free allowances is fixed to a certain percentage (~41%)<sup>29</sup> of the total available emission allowances. This is to ensure that the overall emission ceiling is respected and the amount of allowances available for Member State auctioning and innovation funds remains predictable. If the demand for free allowances exceeds the fixed limit, a cross-sectoral correction factor is applied to reduce the amount of free allocation to each industrial installation accordingly.

The Commission’s proposes that if *trade intensity x emissions intensity* results in a value of above 0.2 kg CO<sub>2</sub> per EUR Gross Value Added, the sector should receive 100% of its benchmarked allowances for free.<sup>30</sup> Otherwise, the sector would be considered ‘not at risk’ but would still receive 30% for free. This means that even industries that are not at very high risk of delocalization as a result of the ETS would receive 100% free allocation just as very highly exposed sectors are. Sectors considered having no risk of carbon leakage (below the 0.2 threshold) would receive 30% of allowances up to their benchmark for free. In total 94% of industry’s emissions would be on the “carbon leakage list” and receive 100% of their allowances up to their benchmark for free<sup>31</sup>. The European

<sup>29</sup> Impact assessment see [here](#), p.25: "In total, the free allocation over phase 3 is thus expected to be around 41% of the total amount."

<sup>30</sup> *The value of 0.2 refers to the emissions intensity and the Commission’s Impact Assessment states that a value of 0.2 is very low: Finally, a low threshold is proposed to identify those sectors for which carbon costs represent a marginal share in their GVA, and therefore are deemed not much economically affected by the ETS. The threshold of 0.2 kg CO<sub>2</sub> / EUR Gross Value Added (GVA) is equivalent to a CO<sub>2</sub> cost intensity of 0.5% in the current ETS Directive, and was selected since it is considered that below this carbon cost level the economic impact of the ETS is minimal, and thus the risk of carbon leakage very low.*  
[http://ec.europa.eu/clima/policies/ets/revision/docs/impact\\_assessment\\_en.pdf](http://ec.europa.eu/clima/policies/ets/revision/docs/impact_assessment_en.pdf), p. 149

<sup>31</sup> Ecofys (2015), see here: <https://twitter.com/bramborkent/status/621345390902779904>

Commission further proposes that sectors with a threshold between 0.18 and 0.2 could also apply to receive 100% allowances based on a **subjective (qualitative) assessment** by the European Commission . The European Commission estimates that this way around 6.3 billion allowances would be allocated for free to companies over the period 2021-2030 – worth as much as EUR 160 billion.

The total number of free allowances is limited in order to maintain the share of allowances to be auctioned and to leave room for innovation funds (see below). Since the proposed free allocation rules are overly generous and highly untargeted, it is very likely that the limit on the amount of free allowances will be exceeded. This makes it necessary to apply the correction factor in the post-2020 period to reduce the amount of free allocation to each industrial installation accordingly. This situation can be avoided if free allocation of emission allowances is reserved for those industrial sectors that are really considered to be at risk of delocalization in the future due to the ETS.

#### **CAN EUROPE CALLS FOR**

- **A tiered approach which means a targeted multi-step approach reflecting actual risk of carbon leakage should be used to limit free allocation, including a pathway to move to 100% auctioning of emission allowances.** If a more targeted approach to carbon leakage is chosen, there is no need to apply a correction factor (which reduces the free allocation to all industrial sectors equally). This should lead to less emission allowances given away for free and these left-over free allowances should be cancelled, or auctioned for innovation support.
- **The trade intensity of an industrial sector that determines the exposure to “carbon leakage” should exclude the trade to third countries that have implemented emission reduction policies comparable to the ETS.** The Paris climate agreement and further international progress should inform future assessments of carbon leakage risk to sectors covered by the ETS.
- **Sectors that are not at risk should not receive any free allowances after 2020.** This includes all sectors that are below the factor 0.2 and hence should be subject to 100% auctioning.
- **Restrict the validity of the carbon leakage list that determines which industries are eligible for free allocation of allowances to maximum 5 years.** Regularly updating the list is important to ensure the list reflects the rapidly changing global market developments, inter alia taking into account the comparable efforts of other countries (for the trade intensity criterion) and new evidence on the cost-pass through rates of sectors.
- **Exclude the option that would allow the European Commission to add sectors on the carbon leakage list based on a subjective, “qualitative” assessment.** This ensures that the assessment of the exposure of sectors to the risk of carbon leakage is made in the most transparent, democratic and objective way possible.

### 3.5 INDIRECT COSTS

Electro-intensive companies in several countries<sup>32</sup> are subsidized for possible “indirect costs”<sup>33</sup> that are the result of higher electricity bills because of the possible impact of the ETS on power prices. A study for the European Commission has concluded that indirect costs did not have a significant effect on the risk of carbon leakage in most industries<sup>34</sup>.

Compensating electro-intensive industries for their indirect coal consumption hampers the transition to an efficient, climate-friendly energy system as it reduces the incentive to purchase low-carbon electricity. Little information is available on the amount of subsidies that are given to industry to compensate them for their high-carbon power consumption. Germany has for example budgeted €756 million for indirect cost compensation in the 2013-2015 period<sup>35</sup>. See also section 3.2 on windfall profits.

Currently Member States “may” provide compensation for indirect carbon costs in line with State aid rules. This is changed to “should” in the recent ETS revision proposal, where it is also specified that Member States should use the revenues from auctioning in this regard.

Some companies have been overcompensated for potential indirect carbon costs at the moment. The Flemish authorities have for example paid industries four times too many subsidies<sup>36</sup>, based on an unrealistically high emissions intensity factor and carbon price.

#### CAN EUROPE CALLS FOR

- **State aid for indirect costs should not be allowed** in order to keep the incentive for electro-intensive industry to switch to electricity with lower carbon emissions and avoid a distortion of the EU internal market.<sup>37</sup> Innovation support could instead be directed towards industrial sectors with relative high indirect costs to enable efficiency improvements or a switch to sustainable renewables.

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<sup>32</sup> The Netherlands, Germany, Greece, the UK, Spain, Belgium (Flanders) and Norway.

<sup>33</sup> Installations covered by the EU ETS face *direct* carbon costs when buying their CO<sub>2</sub> emission allowances at auction. Consumers of energy and industrial products can face *indirect* costs when the costs of carbon emissions related to their consumption are being passed through to them. Indirect carbon costs are the logical result of how the “polluter-pays” principle is implemented in the EU ETS. If a consumer buys a car for example, the carbon costs of the steel used to produce that car are passed on to him or her. The consumer hence pays indirectly for the carbon pollution it has caused.

<sup>34</sup> Ecorys’ Carbon Leakage Evidence Project: Factsheets for selected sectors, September 2013

<sup>35</sup> Other countries that have notified state aid schemes for indirect cost compensation to the European Commission which were approved: the UK with a total budget of GBP 113 million (2013-2015), Greece €128 million (2014-2020), Spain €5 million (2013-2015), the Netherlands €156 million (2014-2015) and Belgium €304 million (2013-2020)

<sup>36</sup> See: <http://deredactie.be/cm/vrtnieuws/videozone/programmas/dezevendedag/2.33122?video=1.1951459>

<sup>37</sup> Sandbag does not agree with this recommendation.

## 4. FUNDING CLIMATE ACTION THROUGH THE ETS

A price signal alone, even if it was considerably higher, will not be sufficient to facilitate the transformation that is needed to avert dangerous climate change. We also need bold policies and financial support for investments in technology development and dissemination. There are several opportunities in the ETS to generate such financial support:

1. The Innovation fund (formerly NER 300);
2. The Modernization fund;
3. The provision in Article 10c;
4. The use of auctioning revenues for EU and international climate action;
5. An International Climate Action Reserve;
6. A Just Transition Fund.

### MAIN PRINCIPLES

It is imperative that all the above public financial flows adhere to the following main principles:

1. **Only emissions reductions of at least 95% or higher by 2050 can ensure some chances of staying below 1.5°C warming.** Therefore all financial support to projects in EU Member States must fit within national and European decarbonisation strategies, and help the implementation of all EU climate and energy policies. **Therefore to be eligible for funding Member States must ensure full transposition of all relevant EU legislation;**
2. **All financial support to projects in the energy sector should contribute to the transformation of the energy system with the objective to phase-out greenhouse gas emissions and the use of fossil fuels, to reduce energy consumption and to provide 100% of all energy from sustainable renewables. This includes support to innovative investments in grid connections and storage infrastructure;**
3. **No financial support shall be given to fossil fuel based or nuclear energy production<sup>38</sup>;**
4. **All financial support shall give priority to investments for energy savings and sustainable renewable energy technologies;**
5. **Ensure the “energy efficiency first” principle: projects that increase energy supply through new installations or the modernization of old ones shall only receive funding if they can demonstrate that it would not be more effective to instead implement energy efficiency measures and reduce energy demand;**
6. **Only bio-energy projects that adhere to specific and strict sustainability criteria and correct carbon accounting shall be eligible for funding (see chapter 5);**
7. **Require additionality: financial support shall be limited to projects that would not be implemented for other reasons, e.g. financial support shall not be used for so called “necessary restructuring” to comply with air-pollutant limits under the Industrial Emissions Directive;**
8. **Priority shall be given to projects that promote co-benefits, such as improving air quality, reducing energy poverty, and promoting cooperation between Member States and regional integration;**
9. **Full transparency shall be ensured in the selection and implementation of all projects and investments, as well as in the development of selection criteria and the decision-making processes.** All information must be publicly available (with an official English translation) on a dedicated website including project documentation, decisions, and monitoring reports. Annual reports on results of the funds shall be presented to European Parliament;
10. **Public consultations shall be set up before decisions are made on the selection criteria and on all projects that will receive financial support.** Open consultations on project proposals of at least 30 days, ensuring full accessibility of relevant documents and ensuring comments raised by stakeholders are fully taken into account;
11. **For all financial support received, full and independent monitoring, reporting and verification shall be ensured.**

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<sup>38</sup> Sandbag does not support the second half of this position.

## 4.1 INNOVATION FUND (FORMALLY NER 300)

The Innovation Fund aims to support first-of-a-kind investments in renewable energy, carbon capture and storage (CCS) and low-carbon innovation in energy intensive industry. 400 million allowances, according to the Commission's estimates representing up to EUR 10 billion (others put the estimates considerably lower), will be reserved from 2021 onwards for this purpose. In addition, 50 million of the unallocated allowances from the 2013-2020 period will be set aside to enable the Innovation Fund to start before 2021 and include projects to support breakthrough technologies in industry.

The projects funded by the NER300 until now have delivered questionable results. It is therefore of vital importance that the Innovation Fund focuses on projects that can catalyse the transformational change needed.

### CAN EUROPE CALLS FOR

- **The Innovation Fund to adhere to the main principles listed at the beginning of this chapter.**
- **Creating a significantly larger Innovation Fund.** Under the current EU ETS revision proposal, indirect subsidies for pollution are much higher than support for innovations: currently, the number of allowances used to subsidise industry pollution through free allocation (6.3 billion) is 14 times higher than the number of allowances used to help industries decarbonise through innovation support (450 million). Phasing out free pollution permits and earmarking part of the left-over allowances for innovation can help correct this unbalance;
- **Establishing an absolute cap of € 300 million that can be awarded to one project.**<sup>39</sup> The current relative cap (15% of the total budget) proposed by the Commission would allow for a few mega projects being funded instead of enabling a wide range of different projects. A cap of € 300 million is sufficient to provide 50% co-financing for most technological innovations. This level of support is sufficient to leverage other types of funding (notably private) and therefore significantly increase total delivery of the Fund. Research shows that this holds true even for capital intensive sectors like steel mills, copper smelters, offshore wind parks, bio-refineries or solar thermal power plants.<sup>40</sup>

## 4.2 MODERNISATION FUND

The Modernisation Fund aims to support lower income Member States in meeting their high investment needs related to energy efficiency and the modernisation of their energy systems. Between 2021 and 2030, 2% of the allowances, some 310 million allowances in total, will be set aside to establish the Fund. The Commission estimates that at an average allowance price of EUR 25.8 their sale would generate approximately €8 billion.<sup>41</sup> All Member States will contribute to the fund, which will benefit 10 Member States with a GDP per capita of less than 60% of the EU average (in 2013). The countries eligible to receive support are: Poland – 43.41%, Czech Rep. – 15.59%, Romania – 11.98%, Hungary – 7.12%, Slovakia – 6.13%, Bulgaria – 5.84%, Croatia – 3.14%, Estonia – 2.78%, Lithuania – 2.57%, Latvia – 1.44%.

The Modernisation Fund is a new policy measure, but its policy objective is similar to that of the Article 10c derogation of the current Directive for optional free allocation to the power sector.<sup>42</sup> The design of the

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<sup>39</sup> Sandbag does not support this position.

<sup>40</sup> See <https://www.adelphi.de/de/publikation/project-volumes-and-co-financing-rates-industrial-sector-innovation-fund>

<sup>41</sup> See the [2015 Commission's Impact Assessment](#) (p. 54), [http://ec.europa.eu/clima/policies/ets/revision/docs/impact\\_assessment\\_en.pdf](http://ec.europa.eu/clima/policies/ets/revision/docs/impact_assessment_en.pdf).

<sup>42</sup> See the [2015 Commission's Impact Assessment](#) (p. 82), [http://ec.europa.eu/clima/policies/ets/revision/docs/impact\\_assessment\\_en.pdf](http://ec.europa.eu/clima/policies/ets/revision/docs/impact_assessment_en.pdf).

Modernisation Fund should therefore draw on the experience of Article 10c and ensure a more effective spending. The current EU ETS reform proposal focuses exclusively on the governance structure of the fund, and lacks provisions to ensure its use will drive the needed decarbonisation.

#### **CAN EUROPE CALLS FOR**

- **The Modernisation Fund to adhere to the main principles listed at the beginning of this chapter;**
- **The exclusive focus on energy savings and sustainable renewable energy to be ensured by strict overall project eligibility criteria in the EU ETS directive<sup>43</sup>;**
- **The Modernisation Fund to particularly support (small-scale) projects** that bundle energy efficiency, decentralised renewable energy solutions and community-driven integrated approaches, in particular local sustainable energy action plans developed by local and regional authorities;
- **The Modernisation Fund to build on existing experience** with the cooperation between the European Commission and the European Investment Bank (EIB), and draw on features of the European Fund for Strategic Investments (EFSI) and the existing Cohesion Policy implementation including the role of national and regional managing authorities;
- **The EIB, the European Commission and all Member States to be involved** in the Fund's management and be represented on the Investment Board;
- **The European Commission to be responsible for the overall management including development of detailed eligibility criteria and monitoring and verification of projects' implementation.** The detailed eligibility criteria put forward by the Commission shall undergo a public consultation with stakeholders;
- **Broad local participation:** The governing bodies in the recipient Member States must include representatives from beneficiary countries' partnership structures, such as managing and environmental authorities, local and regional authorities and civil society organisations;

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<sup>43</sup> Sandbag does not support this position.

### 4.3 ARTICLE 10C

Article 10c allows the same Member States that benefit from the Modernisation Fund to hand out up to 40% of their auctionable allowances for free to installations in the power sector if they have undertaken modernisation investments whose value is equal to, or exceeds, the value of those allowances (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia). This would amount to close to 700 million allowances being handed out for free over the 2021-2030 period.

The current rules state that to be eligible, in 2006 more than 30% of electricity needed to be produced from a single fossil fuel, and the GDP per capita did not exceed 50% of the average of the EU. The reform proposal of the Commission no longer includes the fossil fuel dependency criterion and instead uses a single criterion of a lower than 60% GDP per capita.<sup>44</sup>

From 2021 onwards, the preferred approach should have been to ensure power producers in all EU Member States buy 100% of their allowances at auction. The continuation of transitional free allocation for power generators can distort competition, hinder the completion of the EU Internal Energy Market and endanger the EU's long-term decarbonisation objective.

Current 10c investments have overwhelmingly benefited fossil fuel based plants.<sup>45</sup> At the same time, emissions from power stations that have received such support have been falling much slower than the emissions from all other EU power installations.

#### **CAN EUROPE CALLS FOR**

- **Article 10c to adhere to the main principles listed at the beginning of this chapter.**
- **The exclusive focus on energy savings and sustainable renewable energy to be ensured by strict overall project eligibility criteria in the EU ETS directive<sup>46</sup>;**
- **To particularly support (small-scale) projects** that bundle energy efficiency, decentralised renewable energy solutions and community-driven integrated approaches, in particular local sustainable energy action plans developed by local and regional authorities.
- **The single fossil fuel dependence criterion to be reinstated at 40%;**
- **The GDP criterion for 10c to remain at 50% and not to be raised to 60% of the EU-28 average in 2013;**
- **The share of allowances available for allocation to the power sector to decline from 40% in 2021 down to 0% in 2030;**
- **The €10 million threshold for bidding to be removed and all investments to be selected through a competitive bidding process, based on strict rules;**
- **Broad local participation:** The governing bodies in the recipient Member States must include representatives from beneficiary countries' partnership structures, such as managing and environmental authorities, local and regional authorities and civil society organisations;

### 4.4 AUCTIONING REVENUES FOR EU AND INTERNATIONAL CLIMATE ACTION

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<sup>44</sup> [2003/87/EC EU ETS Directive](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02003L0087-20140430&from=EN) Article 10c (1), <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02003L0087-20140430&from=EN>.

<sup>45</sup> For detail, see the [2015 Commission's Impact Assessment](#) (p.133).

<sup>46</sup> Sandbag does not support this position.

The European Commission's ETS reform proposal recommends that Member States (“should”) use 50% of auctioning revenues for climate action. Leaving this open to voluntary action from Member States is a missed opportunity to ensure transparency, predictability and additionality to climate finance domestically and internationally. All ETS auctioning revenues must be earmarked for supporting climate policies, inside the EU and internationally.

#### **CAN EUROPE CALLS FOR**

- **All ETS auctioning revenues to be earmarked for supporting climate policies, inside the EU and internationally.** The reporting obligations under the Monitoring Mechanism Regulation can serve as a good basis to make this earmarking mandatory for all. Reinvestments of auctioning revenues into renewable and energy saving technologies, as well as adaptation action can create a virtuous cycle, where application of the ‘polluter pays’ principle can support investments in the tools needed for further decarbonisation and climate resilience, in the EU and internationally.

### **4.5 ESTABLISH INTERNATIONAL CLIMATE ACTION FUND**

The Paris climate deal re-commits developed countries to deliver 100bn USD/year by 2020, and extends the goal until 2025, while pledging to significantly increase adaptation finance from current levels. So far, the EU has mainly, and particularly for adaptation, turned to aid budgets alone as a source of climate finance, and the use of auctioning revenues to help diversify sources has been minimal and unpredictable.

Instead of relying on existing aid flows, which in the large majority of EU countries have not even reached the pledge to deliver 0.7% of GNI, auctioning revenues must provide an additional, predictable, consistent, significant, and reliable revenue stream to help increase overall climate support, and eventually supply financial support that goes beyond the 0.7% aid commitment. The ETS should also include a fund that supports developing countries who are most impacted by climate change.

Setting aside a portion of ETS revenues as climate finance for adaptation and mitigation in poor countries would allow the EU to (i) help increase the mitigation ambition of developing countries; (ii) provide a real additional solution to the growing cost of adapting and dealing with climate change and (iii) position the EU as a shaper of a new emerging global climate-finance architecture, including for carbon pricing.

#### **CAN EUROPE CALLS FOR**

- **Establishing an International Climate Action Fund.** The International Climate Action Fund would be modelled on the Innovation and Modernisation fund, so that earmarking is not necessary at a Member State Level. It would be replenished with a portion of ETS allowances, with revenues automatically and predictably channelled as climate finance, for example through UN climate funds like the Green Climate Fund. For example, a single EU mechanism within the ETS, setting aside 5% to 10% of emissions allowances could raise €15 - €35 billion over the period 2021-2030 (estimated average carbon price of €22.5 per EUA).<sup>47</sup> A total of €35 billion would triple current contributions from the EU to the Green Climate Fund.

### **4.6 ESTABLISH A JUST TRANSITION FUND**

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<sup>47</sup> Calculations from Institute of European Studies in study commissioned by Oxfam: Automatic revenue raising for international climate finance through the European Emissions Trading System, May 2015.

The European Commission recognises that it is important to support workers in the low-carbon transition. In its ETS reform proposal, the Commission introduces as one of the possible uses of 50% of the ETS revenues by the Member States: *“to promote skill formation and reallocation of labour affected by the transition of jobs in a decarbonising economy in close coordination with the social partners”*. However, voluntary measures are not sufficient to address the social impacts of the low-carbon transition.

Instituting a Just Transition Fund as a strong and EU-wide support mechanism for workers and regions that will lose out in the course of the low-carbon transition would address heads on one of the key problems in promoting stronger EU energy and climate policies.

#### **CAN EUROPE CALLS FOR**

- **The establishment of a Just Transition Fund** to support local communities and workers in regions impacted most strongly by the ongoing transition to a decarbonised economy. At least 100 million allowances should be reserved for this purpose in the period 2021-2030;
- **The fund’s resources should be used** for job creation in alternative economic activities in regions where traditional carbon intensive sectors will lose a large number of jobs as a result of decarbonisation. Such a fund should finance, for example, job training and other employment and health services for workers and communities impacted by the closure of specific plants;
- **A specific plan should be developed by each Member State** applying to utilise resources from this fund, in close partnership with the municipal and local authorities of the transformation regions as well as the social partners and civil society organisations.

## **5. ENSURING ETS INCENTIVIZES ONLY SUSTAINABLE BIOENERGY USE**

The majority of renewable energy consumed in the EU is bioenergy<sup>48</sup>. At least half of the biomass consumed for power and heat in the EU in 2012 was burned in ETS regulated installations. This use of biomass is erroneously rated as having zero greenhouse gas emissions. This is incorrect because it ignores the emissions from land and forests resulting from increased harvesting, depletion of carbon stocks, and emissions from direct or indirect land use change. In addition, solid and gaseous bioenergy does not need to comply with sustainability criteria of any kind.

The zero rating of carbon emission from biomass undermines the ETS target and is a subsidy to industries that use such bioenergy. Based on the reporting of Member States, ETS installations that burn biomass create unaccounted emissions of 90 - 150 million tonnes of CO<sub>2</sub>e per year. This is the equivalent of 4-7% of total allowable ETS emissions<sup>49</sup>.

The European Commission has promised a new sustainability policy for all bioenergy in the new 2030 framework. The legislative proposal will likely be released in the second half of 2016. This new framework must reassess the zero emission rating of bioenergy and apply to the ETS. The sustainability framework applying to biomass used under the ETS should include the following elements: a cap to limit the use of biomass for energy<sup>50</sup>, ensure efficient use of biomass resources that prioritizes long lived products and materials over energy use, full carbon accounting of bioenergy emissions and environmental safeguards.<sup>51</sup>

#### **CAN EUROPE CALLS FOR:**

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<sup>48</sup> [http://ec.europa.eu/eurostat/statistics-explained/index.php/Renewable\\_energy\\_statistics](http://ec.europa.eu/eurostat/statistics-explained/index.php/Renewable_energy_statistics)

<sup>49</sup> See [Reasons to change the zero-rated criteria for biomass in the EU ETS](#)

<sup>50</sup> Sandbag does not agree with a cap.

<sup>51</sup> For more details see: [Pitfalls and potentials - The role of bioenergy in the EU Climate and Energy Policy Post 2020](#)

- **The ETS Directive must subject the use of biomass to comprehensive sustainability criteria and correct carbon accounting.** The ETS reform needs to ensure that it follows the new framework on biomass, as outlined above. The zero rating of biomass greenhouse gas emissions has to be revised in order to ensure that the ETS better reflects the balance of the net effect of the production and use of bioenergy and gets rid of perverse incentives that can increase greenhouse gas emissions.
- **Reporting and transparency on the use of biomass under the ETS needs to be improved to allow for a better assessment of the kind of bioenergy used.** Reporting of CO<sub>2</sub> emissions from biomass both at an installation and Member State level must be mandatory and made public. Bioenergy-only installations that are larger than 20MW should be included under the monitoring and reporting regulation. To have a better understanding of the environmental impacts, the regulation should also include more detailed requirements on the kind of biomass used in the installation (e.g. whether it is from forestry, agriculture, the kind of wood or crop used etc.).
- **ETS funding for bioenergy use must follow strict sustainability criteria.** ETS support from the innovation and modernization funds and through article 10 c must be conditional to strong safeguards that ensure the long-term sustainability of bioenergy projects, see recommendations on funds in chapter 4.

## 6. ADDRESSING EMISSIONS FROM AVIATION AND SHIPPING

Emissions from aviation and shipping pose a great challenge for EU climate policy. The Council and the European Commission have called for actions that cover all sectors and sources of emissions<sup>52</sup>, including international aviation and shipping. But currently only intra-European flights are included in the ETS.<sup>53</sup> The emissions of international flights departing from or arriving in the EU have been temporarily excluded from the ETS and maritime emissions are not included at all in the EU's 2020 climate commitment.

The UN bodies tasked with tackling emissions from these sectors (ICAO for aviation and IMO for shipping) have failed for decades to agree measures to reduce emissions in their sectors. On the contrary, emissions from international aviation have grown by 76 % between 1990 and 2012 and from international maritime transport by 70% since 1990.<sup>54</sup> CO<sub>2</sub> emissions from international transport are substantial. Compared to country emissions, maritime transport ranks between Germany and Japan while international aviation CO<sub>2</sub> emissions equal those of the UK.

Shipping emissions are projected to increase by 50% to 250% by 2050 which would then represent between 6% and 14% of total global emissions under a 2 degree scenario.<sup>55</sup> International aviation emissions are expected to grow by up to 300% by 2050, which would then represent between 4% and 15% of allowable emissions under a 2 degree scenario.<sup>56</sup>

**International aviation** is currently exempt from fuel taxation and from intra-EU VAT and there are no meaningful fuel efficiency standards. In 2013, ICAO defined a basket of measures designed to help achieve ICAO's global purely voluntary, aspirational goals. This basket includes: aircraft technology; a CO<sub>2</sub> standard for

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<sup>52</sup> SWD(2015) 17 final: [The Paris Protocol – A blueprint for tackling global climate change beyond 2020](#)

<sup>53</sup> The inclusion of inner European flights will require airlines to reduce emissions or purchase allowances or offsets of almost 65 million over 2013-2016, see <https://www.ecac-ceac.org/action-plans-publicly-available>.

<sup>54</sup> <http://unfccc.int/resource/docs/2014/sbi/eng/20.pdf>

<sup>55</sup> [Third IMO Greenhouse Gas Study 2014](#)

<sup>56</sup> David S. Lee, Ling Lim, Bethan Owen [Shipping and aviation emissions in the context of a 2°C emission pathway](#)

new aircraft; operational improvements; sustainable alternative fuels; and a global market-based mechanism covering international (not domestic) flights.

Giving in to international political pressures, the EU temporarily exempted flights to non-EU destinations from the ETS until the end of 2016 – a measure called “stop the clock”. The scope of intra-EU and domestic aviation in the ETS amounts to only 27% of the EU’s total aviation emissions. The remaining three quarters of emissions, which come from international flights, remain unregulated.

The 2016 triennial ICAO assembly agreed to establish a global offsetting mechanism for international aviation, known as the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA). CORSIA is completely out of step with the temperature goals of the Paris Agreement, purely relies on offsets and does not require any in-sector reductions. It also is not legally binding until at least 2027 and does not include comprehensive accounting or offset quality rules. It is very unlikely that all these issues will be addressed at the next ICAO assembly in 2019.

**Shipping** is currently the only transport sector not contributing to the EU climate targets, despite the fact that CO<sub>2</sub> emissions from maritime transport related to the EU increased by 48% between 1990 and 2008. In line with the growth projections of world trade, EU-related emissions from shipping are expected to increase by a further 86% in 2050 compared to 1990-levels. Therefore, shipping must be included in the EU’s 2030 reduction target. The EU has promised numerous times to tackle shipping emissions, see also EU climate legislation in 2009<sup>57</sup> and the Commission’s 2011 White Paper on Transport.<sup>58</sup> In the Commission’s 2013 Communication setting out a strategy for maritime emissions<sup>59</sup>, it announced that the Regulation on shipping monitoring, reporting and verification which took effect in mid-2015 would be followed by the adoption of a reduction target and by implementing measures including a Market Based Mechanism. The EU should now make clear how it intends to deliver shipping reductions within its 2030 commitment by establishing just such an EU reduction target and measures, as little can be expected from the IMO which is mired in dissension.

#### **CAN EUROPE CALLS FOR:**

- **The ETS should cover all domestic and all outgoing and incoming international flights from 2017 onwards. This scope must remain in place for the 4<sup>th</sup> trading period, except if at its 2019 assembly ICAO was to: 1) substantially increase CORSIA’s target to be in line with the Paris temperature commitments, 2) make CORSIA legally binding from 2021 onwards, 3) include comprehensive accounting rules and 4) require substantial in-sector reductions.**
- **Aviation in the ETS should be subject to the same 2030 emissions reduction target as the other ETS sectors.**
- **The aviation sector should not receive any free allowances from 2017 onwards and the auctioning revenues should be earmarked for the Green Climate Fund.** As both intra-EU and international flights should be included in the ETS from 2017 onwards, aircraft operators should be able to fully pass through the carbon costs to their customers (and hence do not face “carbon leakage” risks that could justify the hand-out of free allowances).
- **The CO<sub>2</sub> emissions from aviation should be subject to a multiplier of at least 2** to address the additional climate impacts caused by aviation, as also proposed by the European Parliament. The full climate impact of aviation is between 2 to 5 times higher than that of its CO<sub>2</sub> emissions alone.<sup>60</sup>

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<sup>57</sup> DIRECTIVE 2009/29/EC, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0029&from=EN>

<sup>58</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011DC0144&from=EN>

<sup>59</sup> [http://ec.europa.eu/clima/policies/transport/shipping/docs/com\\_2013\\_479\\_en.pdf](http://ec.europa.eu/clima/policies/transport/shipping/docs/com_2013_479_en.pdf)

<sup>60</sup> [Aviation and global climate change in the 21st century](#) and [SEI Discussion Paper Carbon Offsetting & Air Travel Part 2: Non-CO<sub>2</sub> Emissions Calculations](#)

- **Timeliness and increased transparency in the enforcement of aviation in the ETS, including a clear deadline for when Member States must publish lists of non-complaint airlines.**
- **All shipping emissions should be included within the 2030 ETS emissions reduction target in line with the 2013 Commission’s Impact Assessment from 2021 onwards. In addition, a compensation fund should be established under the ETS Directive.** Shipping companies should not receive any free allowances and the auctioning revenues should be earmarked for the Green Climate Fund. Shipping companies would be allowed to opt out and contribute to a compensation fund before the decision on the number of allowances to be auctioned is taken<sup>61</sup>.

## **7. ENSURING ROAD TRANSPORT REDUCES EMISSION OUTSIDE OF THE ETS**

Article 24 of the ETS establishes the procedures for unilateral inclusion of additional activities and gases in the ETS. The Council Conclusions of October 2014 include a reminder of that option. As part of the 2030 climate discussions, German carmakers as well as the oil industry have advocated for the inclusion of road transport emissions in the ETS. However, the Commission is not proposing such an inclusion and CAN Europe strictly opposes the inclusion of road transport in the ETS, either at the EU level or at the national level by individual Member States because it would:

1. Delay and reduce the rate of emissions reductions in road transport both at EU and at national level. To achieve significant emission reductions in road transport ETS allowance prices would have to be well above €100. At lower prices no significant emissions reductions could be achieved in the transport sector.<sup>62</sup>
2. Much more effective climate policies for road transport already exist and could potentially be abolished if road transport was included in the ETS. For example, fuel efficiency standards are cost-effective both from the perspective of the driver and society.<sup>63</sup> They also provide a clear and stable framework for investment in low-carbon technology in the transport sector.

### **CAN EUROPE CALLS FOR:**

- **Amending article 24 to ensure that individual Member States are not allowed to incorporate the road transport sector in the ETS.**
- **Including a recital mentioning that incorporating the road transport sector within the activities in the ETS (Annex 1 of the Directive) would not be beneficial for reaching the EU’s long term decarbonisation goals and that fiscal and economic measures and fuel efficiency standards for road transport should be strengthened and implemented.**

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<sup>61</sup> Page 4-5 of the Executive Summary of Commission’s Impact Assessment on the monitoring of the shipping emissions: [http://ec.europa.eu/clima/policies/transport/shipping/docs/swd\\_2013\\_236\\_en.pdf](http://ec.europa.eu/clima/policies/transport/shipping/docs/swd_2013_236_en.pdf)

<sup>62</sup> Cambridge Econometrics: [The Impact of Including the Road Transport Sector in the EU ETS](#)  
 Oeko Institute [Policy mix in the transport sector: What role can the EU ETS play for road transport?](#)  
 Transport and Environment: [Three reasons why road transport in the ETS is a bad idea](#)

<sup>63</sup> See for example, [EC Impact Assessment to define the modalities for reaching the 2020 target to reduce CO2 emissions from new passenger cars](#)



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