POLICY BRIEFING

April 2021

How the EU Modernisation Fund can be a driver for the fossil-free energy transformation

The Modernisation Fund is recognised in the European Green Deal Investment Plan as one of the key funding instruments, potentially providing around €25 billion to support Member States in their transition to a climate neutral society. The Fund will start supporting projects as of 2021. There are many loopholes in its current set-up which can cause a continued lock-in into fossil fuels in the Beneficiary Member States. It is likely that the European Commission will also suggest changes to the Modernisation Fund as part of their legislative proposal for the revision of the Emissions Trading Directive (ETS). Several Member States have been actively calling for an increase of the Fund. This briefing aims to set out a number of principles and demands to ensure that:

- **Projects that will benefit from the Fund focus on renewable energy and energy efficiency investments which are compatible with the climate neutrality, zero pollution, and just transition objectives of the European Green Deal, and do not cause a lock-in into fossil fuels;**

- **The revision of the Modernisation Fund does not provide support for fossil fuels, but becomes a driver for the just transition of our economy based on a highly efficient and 100% sustainable renewable energy system, and does not go against the objectives of the European Green Deal and the EU's commitments under the Paris Agreement.**

BACKGROUND

In December 2020, the European Council agreed on increasing the EU's 2030 climate target to at least 55% net emission reductions and gave the political green light to the European Commission for presenting a broad package of legislative proposals and revisions to key EU climate and energy policies in June 2021, the so-called "Fit For 55" package.

Achieving a higher level of climate ambition will require substantial additional investment, both private and public. The European Commission, in its impact assessment on the 2030 climate target estimates that policy scenarios in line with the at least 55% target will increase additional investment needs to between EUR 65 billion and EUR 102 billion per year. Hence, the discussion about implementing the new level of climate ambition is closely linked to the search for additional funding sources and the question on how the EU's financial resources should be spent over the coming years.

[1] Source: European Commission https://ec.europa.eu/clima/policies/budget/modernisation-fund_en

One source of particular interest in Central and Eastern European Member States is the Modernisation Fund, a new financing tool created under the EU Emissions Trading System (ETS) during its revision in 2018. The Fund will start supporting projects in Phase 4 of the EU ETS, meaning between 2021-2030. Currently, Member States are selecting priority and non-priority investment projects to be supported by the Fund. Once approved by the European Investment Bank and the European Commission, these investment projects will be the first ones to benefit from the Modernisation Fund. The selection and assessment processes, including criteria, are very important as the investment decisions made today will determine the European economy's progress on the pathway to climate neutrality and will have a direct impact on the communities to benefit from these investments.

It is likely that the European Commission will also suggest changes to this Fund as part of their legislative proposals for the revision of the ETS Directive. Several Member States, particularly Poland[2], have been quite active in calling for an increase in these financial resources dedicated to supporting the transition in Central and Eastern European Member States, raising their specific demands for a revamp of the Modernisation Fund over the past weeks and months.

In December, the European Council conclusions also picked up on these demands: "The problem of imbalances for beneficiaries of the Modernisation Fund in not receiving revenues that are equivalent to the costs paid by the ETS installations in those Member States will be addressed as part of the upcoming legislation".

MODERNISATION FUND - THE CURRENT SET UP

The Modernisation Fund has been established through Article 10d of the EU ETS Directive[3] and is accessible for 10 lower income Member States with a GDP per capita at market prices below 60% of the EU average in 2013. These eligible Member States are Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia.

The objective of the Fund is to support investments proposed by the beneficiary Member States, including the financing of small-scale investment projects, to modernise energy systems and improve energy efficiency.

The Modernisation Fund is funded from the revenues generated by 2% of auctioned emission allowances for the period 2021-2030, and additional allowances transferred[4] to the Modernisation Fund by beneficiary Member States - see overview below. The Fund is also recognised in the European Green Deal Investment Plan as one of the key funding instruments, to provide some €25 billion - total amount depending on the expected carbon price revenues - for the EU transition to climate neutrality.

[2] Non-Paper from the Polish delegation, 23 October 2020: https://data.consilium.europa.eu/doc/document/ST-11766-2020-INIT/en/pdf
[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02003L0087-20200101&from=EN
[4] Five Member States, Croatia, Czechia, Lithuania, Romania and Slovakia, opted to do so.

MODERNISATION FUND - THE CURRENT SET UP

The table below shows the total amount of allowances per beneficiary Member State for the period 2021-2030 [5]

Modernisation Fund as per Article 10(1) of ETS Directive	Member States	Share as per Annex IIb of ETS Dir	Allowances as per Article 10(1) of ETS Dir	Transfers from Article 10(2)(b) (solidarity) and Article 10c	Total
2% of cap	Bulgaria	5,84%	16.095.825	0	16.095.825
	Czechia	15,59%	42.968.135	150.184.557	193.152.692
	Estonia	2,78%	7.662.054	0	7.662.054
	Croatia	3,14%	8.654.262	5.978.852	14.633.114
	Latvia	1,44%	3.968.834	0	3.968.834
	Lithuania	2,57%	7.083.265	8.696.818	15.780.083
	Hungary	7,12%	19.623.677	0	19.623.677
	Poland	43,41%	119.643.793	0	119.643.793
	Romania	11,98%	33.018.490	167.747.579	200.766.069
	Slovakia	6,13%	16.895.104	35.011.645	51.906.749
	Total	100,00%	275.613.439	367.619.451	**643.232.890**

The total revenues of the Modernisation Fund may amount to some €14 billion in 2021-30, depending on the carbon price.

Eligibility criteria are set out in Article 10d, paragraphs 1 and 2. No support for solid fossil fuels (coal) is allowed, with the exception of "efficient and sustainable district heating" in Bulgaria and Romania.

In the current funding programme, at least 70 % of the financial resources from the Fund shall be used to support 'priority investments' in renewables, energy efficiency, energy storage and the modernisation of energy networks, including district heating networks, grids for electricity transmission and interconnections. Investments in energy efficiency in transport, buildings, agriculture, and waste can also be eligible. The Fund can be used to support just transition, additionally to the Just Transition Mechanism, in funding redeployment, re-skilling and up-skilling of workers, education, job-seeking initiatives, and start-ups, in dialogue with the social partners.

This means that currently, up to 30% of the Modernisation Fund could still be used for 'non-priority investments' meaning non-solid fossil fuels such as gas or oil shale.

[5] The table shows the share of total allowances each Beneficiary Member State receives from the Modernisation Fund under its current set up in the period 2021-2030. The total amount of allowances set aside for the Modernisation Fund (643 million) consists of two building blocks: i) allowances representing 2% of the cap totaling 275.6 million allowances which are divided according to the percentage shares stated in Annex IIb of the ETS Directive (the respective amount of allowances as per Article 10(1) of the ETS Directive in the central column of the table), ii) transferred additional allowances totaling 367.6 million allowances which can come from two sources: Either they are part of the solidarity transfers of auctioned allowances representing 10% of auctioned allowances according to Article 10 (2)(b) of the ETS Directive[This is the case for Czechia (38.7 million allowances), Romania (81.6 million allowances) and Slovakia (1.7 million allowances)]. Another source of additional allowances is Article 10c which grants lower income Member States transitional free allowances for the modernisation of their energy sector[Additional allowances from Article 10c were transferred by Czechia (11.5 million allowances), Croatia (6 million allowances), Lithuania (8.7 million allowances), Romania (86.1 million allowances) and Bulgaria (33.2 million allowances).]. Five Member States (Czechia, Croatia, Lithuania, Romania and Bulgaria) have chosen to transfer additional allowances.

The current framework fails to ensure consistency of the eligible investments in the Modernisation Fund with the EU's climate neutrality target and engagements under the Paris Agreement, as a requirement.

LOOPHOLES IN THE CURRENT FUND RISK A LOCK-IN TO FOSSIL FUELS

In the current design of the funding programme, there are no robust criteria to assess project alignment with the EU's climate neutrality target. There are many loopholes in the eligibility criteria which risk causing a lock-in to fossil fuels.

The lack of clarity in what the definition of 'priority investments' entails - notably for modernisation of energy networks, including district heating and electricity grids - leaves a door open for increasing the share of gas and oil in the energy mixes of mostly coal dependent countries.

The eligibility criteria the EIB uses for the non-priority investments are listed as: technical and financial viability, CO2 savings, and 'substantial improvement in energy efficiency and emission reductions' for district heating investments. This means neither Emission Performance Standards, nor the eligibility criteria of Cohesion Policy Funds such as the Regional Development or Just Transition Fund, and the EIB's own eligibility criteria for climate action apply to the first roll-out of the Modernisation fund investments. Moreover, the methodology for demonstrating CO2 savings is not spelled out clearly and it is up to the Member State to provide life-cycle-analyses justifying the emissions reductions.

There is also no clear framework for ensuring that investments under the Modernisation Fund are strategic. Nor is there any defined framework to verify that the investments made are the best option in terms of cost and climate action, except for the assessment of the EIB Committee in the case of non-priority investments. This means that the beneficiary Member States can go for investments, including fossil gas, without having any strong obligation to consider whether investments in renewable energy or energy storage and energy efficiency would be more beneficial or cost-effective. Project proposals are likely to be dominated by the most well-resourced stakeholders, running the risk that breakthrough ideas and projects aligned with the needs of local communities are missed or fail to be of sufficient quality to make the final cut.

The exemption given to Romania and Bulgaria for the Fund to support coal for "efficient and sustainable district heating", is outdated as coal has no place in the energy system. This exemption incentivizes Member States to set a very low bar when planning investments to use the Fund.

In fact, the ongoing developments in Romania showcase how the loopholes in the Modernisation Fund can be misused by the beneficiary Member States, and risk a lock in to fossil fuels.

[[7] European Commission's decision on Rescue Aid in favor of Complexul Energetic Oltenia SA: https://ec.europa.eu/competition/state_aid/cases1/202012/284501_2140447_114_2.pdf

As the Romanian coal utility, Oltenia Energy Complex, has been struggling to pay its ETS allowances while keeping its lignite power capacity operational within the EU emission limits (namely, the LCP BREF BAT Conclusions), the Romanian government stepped in to provide rescue aid. The European Commission accepted this, with the condition that the utility provides a restructuring plan that lowers CO2 emissions and makes the company viable in the future. The utility has recently proposed a restructuring plan which includes using the Modernization Fund to replace its lignite capacity with (mostly) gas (by converting 2 of the coal units to fossil gas, with a total capacity of 1325 MW) and smaller solar PV projects. There is a lot of doubt regarding the proposed plan's ability to reduce CO2 emissions in line with the EU climate targets. For this and other reasons, the Commission started an in-depth investigation on this case.

ONGOING INVESTMENT PLANS BEHIND CLOSED DOORS

Beneficiary Member States are currently preparing to submit investment proposals they deem eligible for funding, whose priority status will be confirmed by the EIB. Those confirmed as priority investments will directly be decided on their disbursement by the Commission whereas the non-priority investments will go through an assessment by the EIB and then be voted on by the Investment Committee before the Commission's disbursement decision. The information on projects at the national level is very difficult to access, with many local and national stakeholders struggling to get precise information.

Transparency provisions contained in the implementing regulation of the Modernisation Fund and in the ETS directive only foresee ex-post transparency and do not grant interested stakeholders the possibility to know about a project early enough to challenge it in any way. This shows the need for increased scrutiny from CSOs at a national level, in order to be able to challenge the technical assessment put forward by Member States to justify projects.

The first provision needed to improve the transparency of the plan is to open the access to information on projects prior to their approval, as current provisions only give access to implementation reports or depend on the Member State's willingness to share information.

Without clear guidance on the necessity of these projects to be compatible with the European Green Deal objectives, the Fund risks supporting fossil fuel projects, diverging from the EU's Paris Agreement commitments, 2030 and 2050 climate and environmental targets, as well as the just transition agenda, leaving coal-dependent communities locked into other dead-end fuels. Instead, it needs to be designed and implemented with the highest standards of public participation and stakeholder involvement.

Beneficiary Member States, the Investment Committee, the EIB and the European Commission must consider these risks when submitting and assessing the projects.

DISCUSSIONS ABOUT CHANGES TO THE MODERNISATION FUND AND THE NEED FOR STRICTER ELIGIBILITY CRITERIA

As part of the discussion on increased EU climate ambition, several Member States have suggested increasing the size of the Modernisation Fund in order to bridge the increased investment gaps. In this context, the Polish government, in particular, has argued for a "substantial increase" of the Modernisation Fund, or alternatively the creation of a complementary Energy Solidarity Fund. This discussion is linked with the debates around sufficient support for the just transitions in lower-income, high-carbon European economies.

Similar to other sources of EU and public funding that should contribute to the EU's climate objective, the Modernisation Fund must not be misused to lock in fossil and nuclear infrastructure, but needs to accelerate the no-regret rollout of renewables across beneficiary countries.

In the upcoming revision, the eligibility criteria of the Modernisation Fund have to be strengthened. The Fund must exclude all forms of fossil fuels. Moreover, in light of various applicable investment criteria for green financing, the European Commission should both strive for coherence and stringent consistency with international climate commitments.

POLICY RECOMMENDATIONS

In order to ensure that the EU Modernisation Fund fully contributes, and does not contradict the EU's new 2030 climate and environmental ambitions and its long term objectives, we put forward the following recommendations:

- Beneficiary Member States must **not select any fossil fuel investment projects** to be assessed for eligibility under the Modernisation Fund;

- **Transparency** in the selection and the assessment of the eligible projects must be ensured, as well as effective participation and consultation of interested stakeholders at national, regional and/or the EU level;

- The European Commission should publish **additional technical guidance** for the selection and the approval of the first roll-out of priority and non-priority investment projects eligible for the Modernisation Fund - in light of the EU's 2030 climate and environmental objectives;

- The upcoming revision of the EU Emissions Trading System (ETS) should ensure that no ETS funding programme, nor revenue generated at the EU and national level is used to support fossil fuels as this would be in stark contradiction to the **EU's commitments under the Paris Agreement and its 2030 and 2050 climate and environmental goals;**

- The European Commission should **ensure that a review of the Modernisation Fund's consistency** with the EU's 2030 and 2050 climate and environmental objectives are included in the impact assessment of the ETS revision, and provide further guidance on how to improve the eligibility criteria for coherence. This will help **Modernisation Fund criteria be strengthened in the revised ETS, and prevent any support to fossil fuels**, securing that all investments to the energy sector contribute to **much reduced energy consumption** and to **provide 100% of all energy from sustainable renewable sources**, and **just transitions**;

- The **energy efficiency first principle should apply**. The reduction of energy demand is key for achieving Europe's climate and energy goals. To this end, investments in energy efficiency measures such as building renovations should be a priority. This will facilitate the efforts to phase out fossil fuels and shift to a fully renewable-based energy system, helping the EU fulfil its commitments under the Paris Agreement;

- Funding should support renewable energy projects as well as projects that allow for **faster integration of its increasing supply**. This implies a cross-sectoral optimisation of infrastructure planning and operation. Demand and supply in the electricity sector need to interact closely with demand and supply of heat, gas or with mobility needs, e.g. through grids and storage;

- The European Commission should consider including a provision for **technical assistance to municipalities to develop projects under the Modernisation Fund**, in line with just transition plans and updated guidance on eligible projects. This will increase the strategic nature of spending to the implementation of **just transitions** and ensure that projects financed respond to the **needs of communities**;

- The European Investment Bank (EIB) should be consistent with its commitment to stop lending money for fossil fuel projects, especially now to signal alignment with the Paris Agreement, as **the EU Climate Bank**. The assessment of the **non-priority investment projects should be guided by the EIB's energy lending policy**, which foresees the phase-out of unabated fossil fuel energy projects - including fossil gas.

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