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Assessment of the Modernisation Fund two years into operation

Climate Action Network (CAN) Europe is Europe's leading NGO coalition fighting dangerous climate change. With over 170 member organisations from 38 European countries, representing over 1.500 NGOs and more than 47 million citizens, CAN Europe promotes sustainable climate, energy and development policies throughout Europe.

Introduction

It has been two years since the Modernisation Fund (based in EU Emmission Trading System) started operating. As NGOs, we have been closely following the spending as we believe it has the potential to be a real game-changer for lower-income EU Member States to achieve the just energy transition and to narrow down the investment gap for 2030 climate targets. Its absorption is still limited (5 EUR bn worth of investments approved, out of assumed 45 EUR bn available[1]) as countries are focused on using resources from the Recovery and Resilience Facility (RRF) and EU Cohesion Funds, but its importance will grow over the coming years because the simple and flexible application process offers fairly easy access to funding for the beneficiary Member States. We want to draw conclusions from this first stage of spending, especially in light of the ETS Directive revision, which will change the scope and increase the size of the Fund. This briefing highlights that fossil gas-based cogeneration projects are strongly supported by the Fund and this direction of investment would create a risk of a gas lock-in in some beneficiary Member States if this pattern continues.

Key conclusions and recommendations

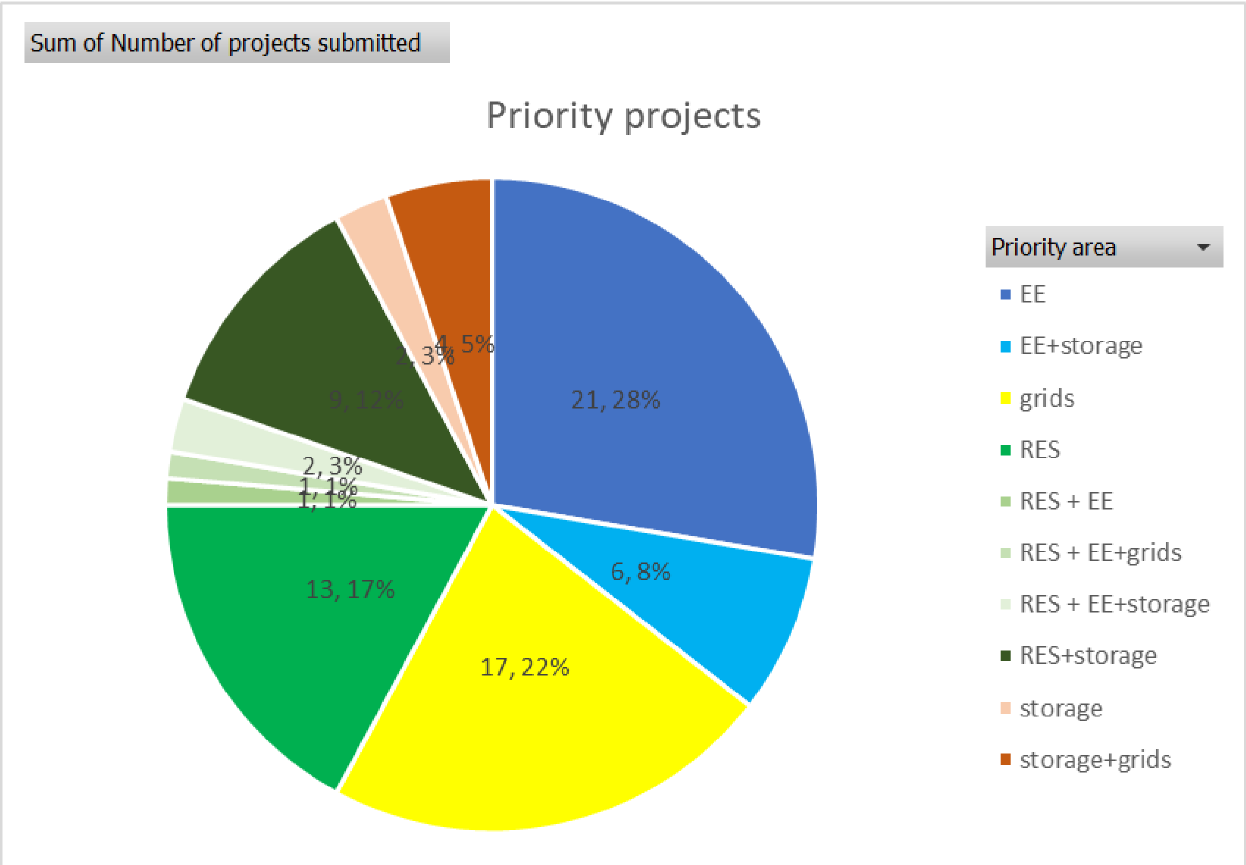
The Fund is meeting the objectives but some elements are needed to improve its operation and expected impact, such as binding national strategies for the spending, a mechanism that will assess the number of gas-based cogeneration units funded via the Fund, and help mitigate the risk of gas lock-in; introduction of incentives to submit more demanding projects like central district heating/cooling, buildings decarbonisation, and energy network modernisation by the beneficiary Member States.

[1] This is assuming 70 EUR EUA price average price for 2021-2030 period

Spendings that can really support modernisation

The Fund as described in the [ETS Directive,](#) should support mainly the five pillars as communicated by the European Commission: renewable energy, energy efficiency, energy storage, energy networks, and just transition in carbon-dependent regions (this means funding redeployment, re-skilling, education, job-seeking initiatives for workers). Currently, 70% of Member States' allocation needs to align with these goals, and corresponding projects are called the 'priority investments'. Based on our assessment the majority of the submitted priority investments are in line with the European Green Deal objectives and the key pillars mentioned above (except for Just Transition, as no project was yet submitted in this area). Looking at the attribution of investments to the pillars published by the European Investment Bank (EIB, responsible for project proofing and overall management of the Fund) the following picture emerges:

Chart 1. Visualisation of the number of investments schemes/projects submitted by the beneficiary Member States, attributed to key categories, according to the tagging provided by EIB data base (as of February 2023). Abbreviations used in the picture are not used by EIB, this is our synthesis for the clarity of visualisation.



The amounts granted to the following categories are (CAN Europe own calculation based on the tracking of funding requested by the beneficiary Members States within 4 disbursement cycles 2021-2022):

- RES and storage - 1,2 billion EUR,
- Buildings - 0,5 billion EUR,
- Energy efficiency in various forms - 0,9 billion EUR
- Energy networks (this covers also energy communities, smart metering, and demand management features) - 1 billion EUR.

Disclaimer: the amounts presented in this briefing reflect resources already disbursed to the beneficiary Member States. We do not have an overview on the full expected funding for each investment scheme as data is not disclosed systematically by the European Investment Bank on the Modernisation Fund website[2]. We are aware that the full expected funding may be significantly higher than the amounts presented here.

Overall, we agree that the Fund is meeting the objectives of the priority projects, expressed in the five pillars.

Spendings that involve fossil fuels

No solid fossil fuels are financed via the Fund until now. The only eligible sort of investment involving coal so far was *"efficient and sustainable district heating"* in Bulgaria and Romania, but fortunately, this was not used by either of the Member States. Romania focused its submissions on investments related to photovoltaics (priority), grids (priority), and coal to gas (as non-priority). Bulgaria has not started submitting any applications at all. After ETS Directive revision (2023), solid fossil fuels are no longer be eligible. So the Fund is not supporting coal.

1) non-priority projects

30% of the funds that a Member State can request can be spent on non-priority investments, which don't have to contribute to the objectives under the five pillars and allow for financing gas power and heat (among other). By March 2023, 22% of granted resources worth 1 bn EUR were allocated as non-priority. Within this, 485 million EUR is used to finance the conversion of power plants from coal to gas in the Czech Republic and Romania, and 50 million EUR for coal to biomass conversion in heat production in the Czech Republic. It means that half of the submitted investments in the non-priority category are controversial in terms of environment and climate protection.

2) the amount of resources allocated to gas-based cogeneration as priority projects

As of March 2023, the investment schemes that are supporting or may support (depending on how the beneficiary Member State has worded the application - some allow for multiple fuels to choose from by end beneficiary) gas-based cogenerations, summed-up, constituted the 6th largest category of spending (see Table 3 in the Annex presenting resources distribution per type of investment).

The Fund's scope allows financing for gas-based high-efficiency cogeneration as an energy efficiency measure, which qualifies as a priority investment. This is because project eligibility criteria were set in 2018, during the last EU ETS directive revision, before the EU committed to

[2] Justification provided by EIB: *"The total funding amount within a scheme will only be known when the duration of the scheme is nearing completion (and all subsequent disbursement requests have been submitted and evaluated). As a result, it is not included in the overall database, which communicates only on disbursed amounts."*

climate neutrality by 2050. Back then, gas, at least to some, still looked like an attractive 'transition fuel' alternative to coal. As a result, The exact definition, which can be found on page 22 of the [assessment guidance document,]reads:

- *High efficiency CHP investment if major amount of electricity is cogenerated at high efficiency on an annual basis;*

Investments in *high efficiency cogeneration* are subject to the criteria of *high efficiency cogeneration* embedded in the Energy Efficiency Directive (EED). The current criteria[3] specify that *high efficiency cogeneration* needs to be 10% more efficient than the separate generation of electricity and heat and do neither explicitly exclude coal nor fossil gas. CHP operators have used this lack of exclusion and put forward coal to gas in heating projects, which enables them to treat this cogeneration as "efficient district heating and cooling". **The Commission's proposal for the revision of the Energy Efficiency Directive** (currently the final technical details are still in negotiation with European Parliament and the Council) introduces a direct emission threshold that would exclude coal, but **still allows fossil gas**. It also specifies that when a cogeneration unit is built or substantially refurbished, Member States shall ensure that there is no increase in the use of fossil fuels except for natural gas. **So regardless of the revision outcome, gas will still be supported and gas-based co-generation will still fall under the Modernisation Fund's "priority" section as an energy efficiency improvement.** This means projects increasing our dependency on fossil gas will have access to the majority of resources for the years 2023-2030.

Cogeneration projects that may support fossil gas were already granted over 300 million EUR - see Table 3 at end of the document. Please note that this number does not represent the full expected funding as multiannual priority investment schemes, once agreed, can ask for subsequent disbursement with shortened procedures. The cogeneration projects come from four countries: Poland, Czech Republic, Slovakia, and Croatia. Those are Member States where the effort of switching district heating from coal to fossil gas is in the making, but if unchecked can lead to dangerous gas lock-in, as we described in the article prepared with the CEE Bankwatch network.

Key legislation for the Modernisation Fund is the ETS Directive which was also revised in 2022, as part of the Fit for 55 package. This was an opportunity for the legislators to make the Fund fossil fuel-free. Despite the effort of the European Parliament, this has not happened, funding gas-based cogeneration in existing installations was agreed to stay eligible for the majority of the Fund[4], as part of the priority section. Only new highly efficient CHPs (combined heat and power plants) using fossil gas were deemed as non-priority, with limits their access to funding and adds additional conditionality[5].

The European Council's fight to keep financing fossil gas via the Modernisation Fund (power generation and CHPs) was very adamant, inspired mostly by CEE countries. While for gas power generation the Parliament and Commission managed to push back and limit the accessible funding, fuel switch to gas in cogeneration facilities can use the resources with little

[3] The Directive is under revision, as part of Fit for 55 package. Revision is expected to conclude in March 2023 (exact date tbc).
[4] 80% of current Fund allocation and 90% of the additional resources to be added to the Fund starting from 2024 (worht of 2,5% all EU emission allowance - EUA).
[5] To be confirmed once final text od revised ETS Directive is published.

restrictions. We can expect more such projects to be submitted. This may put the Commission's credibility into question in terms of dedicating entire block allowances to fund fossil fuels. The Commission should now find a way to make sure that spending on the cogeneration involving fossil gas is kept in check and the risk of gas-lock-in is mitigated.

Table 1. Fossil gas-based cogeneration project financing in four disbursements cycles organised so far [M EUR] (for Poland final amount to be spent on this category depends on the tendering procedure).

Country				
CZ	HR	PL	SK	Grand Total
80.0	40.0	133.5	55.0	**308.5**

Unambitious coal to gas and biomass conversion in district heating

The coal to gas and biomass conversions for CHPs described above, show that Member States have little appetite to submit ambitious projects related to decarbonisation of District Heating & Cooling sources. There are much more favorable low-temperature district heating systems available on the market that involve investing in energy-efficient buildings and non-fuel based RES: solar and geothermal energy, large-scale heat pumps, and seasonal heat storage, that would meet the Modernisation Fund criteria and could be financed. Only three projects were submitted in this area so far, one from Poland (22 million EUR spent, full expected funding to be 444 million EUR) from Hungary (14 million EUR spent), and from the Czech Republic (30 million EUR, full expected funding 2050 million EUR).

Absorption

The beneficiary Member States consuming most of the budget so far is the Czech Republic, followed by Romania. The two Member States that have not started using the Fund at all are Bulgaria and Latvia. Assuming that EUA average prices for the entire Fund operation will fall to 70 EUR, the **absorption rate of the available resources currently is only 11%**, for the first two years.

	Current spending M EUR	**Total allocation including transfers M EUR**
CZ	**1,660.0**	13,520.69
RO	**1,412.7**	14,053.62
PL	**988.2**	8,375.07
SK	**519.5**	3,633.47
HR	**121.9**	1,024.32
LT	**113.0**	1,104.61
HU	**108.3**	1,373.66
EE	**86.8**	536.34
BL	**0.0**	1,126.71
LA	**0.0**	277.82

	5,010	45,026.30

The total assumed allocation of 45 billion EUR includes so-called “voluntary transfers” made by selected countries under the ETS Directive. Those are two targeted systems of distributing additional allowances to Members States with GDP per capita lower than the EU average (“*solidarity provision*[6]” and “*derogation allowances*[7]”). Eligible Member States have a choice to combine them with allowances granted for the Modernisation Fund (the Fund itself is based on revenues from emission allowances). Five Member States opted to do so: Croatia, Czech Republic, Lithuania, Romania, and Slovakia, which means their allocation for the Fund is higher. In terms of the total allocation, for the entire period of the Fund's existence, Romania, Czech Republic, and Poland have the highest share (see Table 2 below).

Lack of long-term planning

According to EU legislation, no requirement for a long-term strategy preparation is put in place, Member States can decide on an ongoing basis how to use the money. They are only required to provide the European Investment Bank - the operator of the Fund - with a 2-year indicative investment list, which is non-binding.

This may result in ad hoc use of the Fund by some countries, satisfying current needs submitted by the government and big utilities (noting that big utilities and institutions are natural end beneficiaries of this Fund as investment schemes need to meet certain criteria of magnitude) instead of following a transparent, long term strategy, that can help kick-off decarbonisation in very challenging sectors (for example in buildings).

It also prevents a staged approach to investing in distribution and heating network modernisation as those projects usually require a long implementation timeline. **We call upon Member States to increase their effort in this regard and prepare binding strategies for Modernisation Fund spending.** An example to follow is the Czech Republic, which has prepared and published a comprehensive strategy on how the government intends to use the resources.

2 pillars underinvested

Network modernisation - more infrastructural projects possible

Just Transition - no projects so far (as TJTPs were approved only end of 2022)

[6] Based on Article 10(2)(b) EU ETS: redistribution system of allowances towards low-income Member States for “the purposes of solidarity growth and interconnections within the Union”, without the requirement to be used towards funding specific projects or investments

[7] Based on Article 10c EU ETS: eligible Member States may give transitional free allocation to installations for electricity generation for the purpose of ‘modernisation, diversification and sustainable transformation of the energy sector. This derogation will be probably removed as part of the ETS revision.

Conclusions

So far, the majority of the submitted projects are in line with the European Green Deal objectives and the Modernisation Fund plays its role in supporting renewable energy deployment, energy efficiency and modernisation of energy and heating networks. But a few elements require attention and a proactive approach by the Commission, as they might put the climate and energy targets in jeopardy due to a gas lock-in risk and slow down the decarbonisation of District Heating & Cooling sources. These are:

- the number of investments made in gas-based cogeneration as priority investments, which amount to over 300 million EUR already and will probably increase during the next disbursements;
- the number of investments made in fossil gas-based power as non-priority investments (485 million EUR);
- problematic coal to gas; coal to biomass district heating investments that disincentives investments in RES based heat sources which are sustainable;
- the problem of unstructured spending by the beneficiary Member States and limited absorption after two years of operation (11%).

Recommendations

1. **Member States** should prepare and publish binding national strategies for planned spending of Modernisation Fund resources. An additional reason to do this (on top of transparency and strategic planning) is the fact that all Member States are encouraged to describe in both quantitative and qualitative terms the financing of each policy and measure included in the updated National Energy and Climate Plans[8] to be submitted to the European Commission in 2023. This includes information on how to use programs under the EU budget, including the Modernisation Fund.

2. **The European Commission** should make sure that under the revised ETS Directive and associated documents (Implementing Regulation and others), there is a mechanism that will assess the number of gas-based cogeneration units funded via Modernisation Fund, their predicted lifetime and the possibility to switch to renewable heat so the gas-lock-in risk is properly assessed and can be mitigated by each Member State.

3. **The Modernisation Fund Investment Committee** (governance body issuing recommendations on the financing for non-priority investments), while assessing gas-based power generation projects or gas-based cogeneration projects, should assess the risk of gas-lock in in a given beneficiary Member State.

4. Modernisation Fund should be used in an optimal way to accelerate the energy transition towards renewable energy and renewable heat sources, and accelerate the decarbonisation in the most demanding sectors (like buildings).

5. In order to enable public scrutiny of the impact of the Fund **the European Investment Bank** should publish data regarding full expected funding for each approved investment.

[8] as per NECP revision guidelines

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Annex:

Table 3. CAN Europe summary of all funds granted within 4 already approved disbursements.

tag	**SUM of Allocated [M EUR]**
green h2	3
energy for industry, gas sources modernisation	5
low emission technology for agriculture	8
Energy communities	9
coal to gas in power and industry	10
public lightening	10
Evs subsidies	15
battery storage	20
ee in enterprises	20
grid for EVs charging	22
manufacturing industry - ee	30
RES in industry	30
transport	32
Digitization of heating networks	33
energy production from municipal waste	44
biogas based cogen	44
coal to biomass in heat	50
energy storage	51
RES based heat	66
buildings insulation	88
PV + storage	100
DH and cooling networks modernisation	117
heat pumps	133
ee in industry	211
waste incineration	221

energy meters	222
replacing gas/coal boilers	300
gas cogen	309
ee in buildings	339
ee in EU ETS	350
coal to gas in power	485
grids	568
RES	1,053
Grand Total	**4,999**

Please note that gas cogen category are the investments that may involve the use of fossil gas (the investment scheme allows fuel switch to various sources, including fossil gas). For the purpose of this briefing this was an important dimension, therefore we decided to tag it with a "gas" label.

Please note that the tagging may not be entirely precise as it was not always possible to judge the precise category of investment based on the adopted decision documents. All possible mistakes are ours.