

# Post-2020 reform of the EU Emissions Trading System

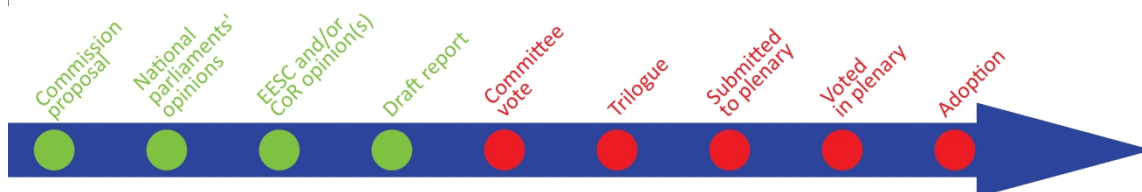
## SUMMARY

In July 2015, the European Commission proposed a reform of the EU Emissions Trading System (ETS) for the period 2021-2030, following the guidance set by the October 2014 European Council. The proposed directive introduces a new limit on greenhouse gas (GHG) emissions in the ETS sector to achieve the EU climate targets for 2030, new rules for addressing carbon leakage, and provisions for funding innovation and modernisation in the energy sector. It encourages Member States to compensate for indirect carbon costs. In combination with the Market Stability Reserve agreed in May 2015, the proposed reform sets out the EU ETS rules for the period up to 2030, giving greater certainty to industry and to investors.

In the European Parliament, the ENVI Committee takes the lead on the proposal, while it shares competence with the ITRE Committee on some aspects. The ITRE Committee adopted its opinion on 13 October 2016; the vote in the ENVI Committee is expected in December.

## Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments

<i>Committee responsible:</i>	Environment, Public Health and Food Safety (ENVI)	COM(2015)0337 of 15 July 2015
<i>Rapporteur:</i>	Ian Duncan (ECR, UK)	<i>procedure ref.:</i> 2015/0148(COD)
<i>Next steps expected:</i>	Vote in ENVI Committee	Ordinary legislative procedure



This briefing updates an earlier edition, of June 2016: [PE 583.851](#).

**In this briefing:**

- Introduction
- Context
- Existing situation

- The changes the proposal would bring
- Parliamentary analysis
- Legislative process
- References

## Introduction

In July 2015, the Commission presented a proposal for reforming the EU Emissions Trading System for the fourth phase (2021-2030), in line with the 2030 climate and energy targets endorsed by the European Council. The proposal lowers the amount of greenhouse gases that may be emitted each year, introduces new rules for protecting industries from 'carbon leakage', and establishes two funds for modernisation and innovation.

The proposal follows recent modifications to the functioning of the EU ETS: the decision to postpone the auctioning of allowances (backloading), and the introduction of a Market Stability Reserve that aims to better align demand for and supply of emission allowances. The proposed reform will provide certainty to industry and to investors by setting the rules for the EU ETS in the period up to 2030.

## Context

The EU ETS is a key element of EU climate policy. In line with the internationally agreed objective of keeping global warming below 2 degrees Celsius, the EU has set targets for reducing its greenhouse gas (GHG) emissions and decarbonising the economy. The long-term objective for 2050, agreed by the European Council in 2009, is an 80-95 % reduction in GHG emissions compared to 1990. In the medium term, the EU aims to reduce GHG emissions by 20 % by 2020, and by 40 % by 2030.

The EU participates in international efforts to reduce GHG emissions under the UN Framework Convention on Climate Change (UNFCCC). The Kyoto Protocol commits developed nations to GHG emissions reductions, up to 2020. In December 2015, the Parties to the UNFCCC adopted the [Paris Agreement](#), a new legally binding climate agreement that applies to all countries. The EU's emissions reduction target for 2030 is part of the EU's Intended Nationally Determined Contribution (INDC) to the Paris Agreement.

Without international cooperation, regional efforts to combat climate change may lose effectiveness, because emission-intensive production may be relocated from regions with strong climate policies to regions with less ambitious policies, a phenomenon known as 'carbon leakage'. If investments are relocated, one speaks of 'investment leakage'.

## Existing situation

The European Emissions Trading System (ETS) was established by the ETS Directive ([2003/87/EC](#)), amended by Directive [2009/29/EC](#) setting out rules for the third phase (2013-20).<sup>1</sup> It is a 'cap and trade' scheme, in which there is a fixed annual number (the cap) of emission allowances, which can be traded among GHG emitters. It covers emissions of CO<sub>2</sub>, nitrous oxide (N<sub>2</sub>O) and perfluorocarbons (PFCs), and applies to more than 12 000 power stations and industrial plants in the 28 EU Member States as well as Iceland, Liechtenstein and Norway, thereby accounting for around 45 % of GHG emissions in these 31 countries. Since 2012, it also applies to the aviation sector.

One EU allowance (EUA) gives its owner the right to emit one tonne of CO<sub>2</sub> or equivalent. In the 2013-2020 period, 57 % of the available allowances are sold in regular auctions, and 43 % are allocated to industry for free.<sup>2</sup> By 30 April of every year, each installation must report its emissions for the preceding year and surrender the corresponding number of EUAs or equivalent international emissions credits. Any unused allowances remain valid and can be used in subsequent years.

The system encourages companies to invest in emissions-reducing technology if the cost of reducing emissions is lower than the market price of emission allowances. If companies find that the cost of reducing emissions is higher than the carbon price, they can buy allowances to cover their emissions. Rational economic actors will thus find the lowest-cost ways to reduce overall emissions.

An EU-wide cap limits total GHG emissions for industrial installations which are subject to the ETS. In order to achieve, by 2020, a 20 % emissions reduction compared to 1990 levels, the cap is lowered by 1.74 percentage points per year, as laid down in the ETS Directive (2009/29/EC). A separate non-declining cap applies to the aviation sector until 2020 (5 % below the average annual emissions in the years 2004-2006).

### Carbon leakage

The European Commission establishes a list of industries that are at risk of carbon leakage – the relocation of production to countries with less ambitious climate policies. The most efficient installations can receive up to 100 % of the required allowances for free. Criteria for inclusion in the carbon leakage list are emissions intensity and trade intensity, assuming a price of €30 per allowance. A new list is established every five years. The second [carbon leakage list](#), for the period 2015-2019, was adopted in October 2014.

A 2013 [study](#) for the European Commission found no evidence of past carbon leakage under the conditions of free allocation to industries on the carbon leakage list, and a low carbon price. Research by [CDC climat](#) found no carbon leakage in the primary aluminium industry, and concluded that energy prices play a much larger role than the cost of emissions.

### Free allocation of allowances

In contrast to the power sector, manufacturing industries receive free allowances. In order to incentivise emissions reductions, the allocation depends on benchmarks set out in [Commission Decision 2011/278/EU](#) on the basis of the average emissions intensity of the 10 % most efficient installations. Sectors at risk of carbon leakage can get up to 100 % of their required allowances<sup>3</sup> through free allocation. Other industries receive only part of the required allowances for free (80 % of their sector's benchmark in 2013, declining to 30 % in 2020). If not enough allowances are available for free allocation, the free allocation for all installations is reduced by a 'cross-sectoral correction factor'.<sup>4</sup> As a result, no installation receives 100 % of the allowances for free, even if it is on the carbon-leakage list, and would have to buy allowances if it does not have reserves.

### Recent developments

In response to an over-supply of allowances, the auctioning timetable for the 2013-20 ETS phase was adapted to allow for the delayed auctioning ([backloading](#)) of some 900 million allowances that would have been auctioned in 2014-16. In May 2015, Parliament and Council agreed on introducing a [Market Stability Reserve](#) (MSR) for the ETS, starting in January 2019. The MSR aims to better align the supply and demand of allowances by placing surplus allowances in a reserve, from which they can be released in case of a shortage. The 900 million backloaded allowances will be placed directly in the MSR. In

January 2016, the Polish government [decided](#) to file a complaint against the MSR with the Court of Justice of the EU, arguing that it will distort the market in the current trading period.

### **Complementary policies**

Emissions from sectors not covered by the ETS, such as road transport, waste, agriculture and buildings, are subject to the Effort Sharing Decision ([406/2009/EC](#)) that sets national emission targets for the non-ETS sector. The Renewable Energy Directive ([2009/28/EC](#)) seeks to ensure that by 2020 renewable energy such as biomass, wind, hydroelectric and solar power make up at least 20 % of the EU's total energy consumption. The Energy Efficiency Directive ([2012/27/EU](#)) sets legally binding rules for end-users and energy suppliers, and requires Member States to establish indicative national energy efficiency targets for 2020. Standards for CO<sub>2</sub> emissions of new passenger cars are set out in [Regulation \(EC\) No 443/2009](#), amended by [Regulation \(EU\) No 333/2014](#).

### **Effectiveness with the ETS**

A [European Commission study](#) and [academic research](#) indicate that the EU ETS has contributed to small but real emissions reductions and had limited but positive impact on investment decisions and innovation, although it appears that some industries have generated [windfall profits](#) by passing on the cost of free allowances to consumers.

By the end of the second phase, the ETS had accumulated a surplus of more than 2 billion allowances. The main reason for this surplus was falling demand during the economic crisis, combined with an inflexible supply of allowances.<sup>5</sup> Due to this oversupply, the EUA price fell to levels that do not incentivise low-carbon investments or the switching from coal to less polluting gas for electricity generation. Analysts expect the surplus to persist until the mid-2020s.

The [European Court of Auditors](#) found weaknesses in the management of the ETS by the European Commission and Member States, and issued recommendations for improving market regulation and oversight.

The Commission's [carbon market report 2015](#) of November 2015 concludes that the EU ETS has created a functioning market infrastructure and a liquid market, with a robust system architecture. It is confident that the EU ETS will regain importance in the coming years, due to backloading and the introduction of the MSR.

The CEPS Carbon Market Forum's [2016 state of the EU ETS report](#) assesses the EU ETS on four criteria, and finds that it functions reasonably well as a market and delivers on emission reduction targets, but does not drive medium-to-long-term change and suffers from an erosion of trust.

### **The changes the proposal would bring**

The Commission proposal concerns phase 4 of the ETS (2021-2030). It consists of three main elements:

1. more ambitious linear reduction factor for GHG emissions,
2. new rules for free allocation and carbon leakage,
3. provisions for funding innovation and modernisation.

### **New linear reduction factor for GHG emissions**

The proposed directive would raise the linear reduction factor of the ETS cap from 1.74 % per year to 2.2 % per year from 2021, in order to achieve a 43 % reduction in GHG emissions in the ETS sector by 2030, compared to 2005 levels. The increased reduction

factor should lead to additional emission cuts of 556 million tonnes CO<sub>2</sub>e during the next decade. Together with emission reductions of 30 % in the non-ETS sector, this should enable the EU to achieve its target of reducing emissions by 40 % by 2030, compared to 1990 levels.

In phase 4, 57 % of the emission allowances would be auctioned, the same proportion as in phase 3. The proposal leaves it up to Member States how to spend the auction revenues, but says at least half of the revenues should be used for climate action, decarbonisation and compensation of indirect emission costs.

Member States would continue to have the option to exempt small installations from the ETS if they make an equivalent contribution to cut emissions.

#### **Free allocation and benchmarks**

As in phase 3, industry would receive free allowances. Installations on the carbon-leakage list would receive up to 100 % of the required allowances for free, others would get up to 30 %. Free allocation would be decided for a period of five years, compared to eight years at present. The free allocation for an installation would be increased in case of increased production. Currently, this is only possible when production capacity is added.

Free allocation would be decided on the basis of benchmarks, based on the 10 % most efficient installations. The benchmarks would be updated twice during phase 4 (for the periods 2021-2025 and 2026-2030), in order to take account of technological advances. The benchmarks would be tightened by 1 % per year by default, in order to account for expected emission reductions through technological progress. For industries with lower potential for reducing emissions, the benchmarks would be reduced by only 0.5 % per year, and for industries with more potential by 1.5 %. According to the Commission, these changes reduce the chance that a correction factor would need to be applied.

The Commission proposes to move 250 million unallocated allowances from the MSR to a 'new entrants' reserve' that can provide free allocation for new market entrants and growing companies.

#### **Provisions for carbon leakage**

The new criteria for establishing the carbon-leakage list would be a combination of emissions intensity and trade intensity. As a result, around 50 industrial sectors would be on the carbon-leakage list, down from 177 at present.<sup>6</sup> Analysts estimate that sectors on the carbon leakage list would still account for over 90 % of EU industrial emissions, down from 97 % currently.

#### **Compensation for indirect costs**

Indirect costs for electricity consumers arise when the cost for electricity producers' emissions is passed on to consumers through electricity prices. Member States are encouraged to compensate such indirect costs for sectors exposed to carbon leakage, subject to state aid rules. However, there would be no obligation and no harmonisation, and thus the legal situation would remain unchanged.

#### **Innovation Fund**

Similar to the existing NER 300<sup>7</sup> fund, the new Innovation Fund would provide financial support for projects in the areas of renewable energy sources and carbon capture and storage. In addition, industrial demonstration projects for low-carbon innovation can be supported. Up to 60 % of project costs can be funded. The fund would be financed by the sale of 400 million allowances, which could raise up to €10 billion, according to the

Commission. In addition, 50 million unallocated allowances from phase 3 would be taken from the MSR, in order to enable the fund to start before 2021.

### **Support for modernisation of energy systems**

The proposal introduces the Modernisation Fund, a new fund for modernisation of energy systems in lower-income Member States.<sup>8</sup> It would be financed by the auction of some 310 million allowances.

In addition, the proposal would prolong the possibility for lower-income Member States to give free allowances to their electricity producers for modernisation of the energy sector. Modernisation projects above €10 million would be selected at national level through a competitive bidding process, and lower-value projects on the basis of objective and transparent criteria.

### **Parliamentary analysis**

An [initial appraisal](#) of the Commission's impact assessment prepared by the Ex-Ante Impact Assessment Unit (DG EPRS) notes that the impact assessment offers a balanced presentation of the different options, but little original analysis.

An [implementation appraisal of the EU ETS](#) performed by the Policy Performance Appraisal Unit (DG EPRS) concludes that the EU is on track to meet its target of 20 % reduction in greenhouse gas emissions by 2020, due to a number of factors including the ETS, whose effectiveness has been affected by a surplus of allowances and weaknesses in implementation. A study on [energy efficiency and the ETS](#) (DG IPOL, 2013) concluded that there are only limited interactions between the ETS and the Energy Efficiency Directive, which concerns mostly non-ETS sectors.

### **Legislative process**

The EP Committee on Environment, Public Health and Food Safety (ENVI) has exclusive competence for the proposal as a whole, except for the provisions on carbon leakage and the innovation and modernisation funds, where competence is shared with the Committee on Industry, Research and Energy (ITRE). The ENVI Committee held a [hearing](#) on 18 February 2016 to discuss the ETS reform with experts, industry stakeholders and NGOs.

The rapporteur, Ian Duncan (ECR, UK), presented his [draft report](#) on 31 May 2016. In line with the dynamic nature of the Paris Agreement, the draft report proposes a review clause for the linear reduction factor, which could lead to a revision following the first global stocktake in 2023. It calls on the Commission to consider the impact of overlapping EU climate and energy policies, and proposes to place allowances in the MSR in case of the closure of power plants. The rapporteur believes it is essential to protect industries at risk of carbon leakage, and proposes amendments that would further focus this protection while ensuring benchmarks are realistic, allocation is more closely aligned with actual production levels and the need to use a cross-sectoral correction factor is avoided. It proposes administrative simplification for small emitters, an enlargement of the Innovation Fund with 150 million unallocated allowances, and provisions for increased transparency of the Modernisation Fund. The explanatory statement notes that further discussions with legal experts are needed to find a way to address market distortions arising from the fact that only some Member States compensate indirect ETS costs.

In the ENVI Committee, 650 amendments were tabled. They concern the linear reduction factor, the principle of free allocation, the auction share, and a possible tiered approach

for carbon leakage. Many amendments address the issue of auction revenues and some provide for an EU-wide compulsory compensation of indirect emissions costs, thereby ensuring a level playing field. Many Members wished to amend the provisions regarding the Modernisation Fund and Innovation Fund. Several amendments aim to include emissions from the shipping sector. The ENVI Committee is expected to vote in December 2016.

On 13 October 2016, the ITRE Committee adopted its [opinion](#). It rejected the idea of a four-tiered system of free allocation proposed in the draft opinion of Fredrick Federley (ALDE, Sweden), preferring to stay with the Commission's original proposal. The Committee accepted a compromise amendment for an EU fund to compensate industry for the indirect emission costs arising from higher electricity prices, to be financed by the auctioning of 260 million allowances. It voted to increase the share of free allowances if needed to avoid the cross-sectoral correction factor, which could lead to a reduction of the share of auctioned allowances by up to 5 %. The ITRE opinion recommends the creation of a 'just transition fund' (to be financed with the sale of around 177 million allowances) to cope with the impacts of the low-carbon transition, for example by retraining workers in carbon intensive industries. The Committee voted to maintain the linear reduction factor at 2.2 %, but proposed to cancel 300 million allowances from the Market Stability reserve in 2021 as a step towards reducing the surplus of allowances. The ITRE opinion also sets stricter conditions on the Modernisation Fund in order to prevent the allocation of free allowances for coal investments.

In the Council, the Commission proposal was [discussed](#) at working party level under the Dutch Presidency. Environment Ministers held a [policy debate](#) on the proposal on 20 June 2016. They agreed to minimise the need to apply the cross-sectoral correction factor in phase 4 of the EU ETS and supported a more dynamic system for the alignment of free allocations with verified production data. In the press conference, Sharon Dijksma, Minister for the Environment of the Netherlands, underlined the importance of flexibility so that the EU can adapt its level of ambition under the dynamic ambition mechanisms of the Paris Agreement.

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## Endnotes

<sup>1</sup> After an introductory phase (2005-07), the second phase (2008-12) of the ETS was characterised by the allocation of allowances to industry by Member States, and the possibility to make use of international carbon credits. In the third phase (2013-20), more of the allowances are auctioned, the ETS covers more emissions, and a central registry and common auction platform is introduced to increase transparency and prevent fraud. Moreover, the use of international credits has been restricted.

<sup>2</sup> Allowances for electricity producers are subject to auctioning (with the exception of free allocation for the modernisation of the power sector in some Member States), whereas industry receives a proportion of the required allowances for free.

<sup>3</sup> The free allocation is based on historical production data. The amount of free allocation depends on the benchmark; less efficient installations receive only as many allowances as the 10 % most efficient installations would need for the same amount of production.

<sup>4</sup> A cross-sectoral correction factor was first used in 2013, reducing free allocation by 6 %. The factor will rise to 18 % by 2020.

<sup>5</sup> Other factors contributing to the surplus were national allocations of free allowances, cheap international emissions reductions credits and emissions-reducing effects of complementary policies.

<sup>6</sup> The new carbon leakage list is expected to include sectors such as steel, aluminium, chemicals, paper, fertilisers, lime and glass.

<sup>7</sup> The NER 300 fund is financed from the sale of 300 million allowances from the New Entrants Reserve (NER).

<sup>8</sup> Member States whose GDP per capita in 2013 was lower than 60 % of the EU average. These are Bulgaria, Czech Republic, Estonia, Croatia, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia.

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