

EU ETS structural reform: what is on the agenda?

June 29, 2015, Brussels

Andrei Marcu
Head, CEPS Carbon Market Forum

Where are we with ETS reform?

- At the previous CMF meeting on May 6, we started the discussion on what a structural reform of the EU ETS may entail
- We discussed compensation for both direct & indirect carbon costs, different allocation methods for power and industrial sectors, models of free allocation as well as how to support innovation
- An Impact Assessment by the European Commission, on amending the ETS Directive has meanwhile been leaked
- The IA Board rejected the current draft – nevertheless, the leaked draft gives valuable insight into what the EC is considering
- A final IA would accompany an EC proposal for amending the ETS Directive, which may still come before the summer break

Summary of May 6 discussion

- A revision of the EU ETS will likely comprise the following elements:
 - Free allocation:
 - how much of total allocation should be available for free allocation
 - production levels: should they be updated frequently, or even all the time (dynamic allocation)
 - more targeted and gradual approaches may be considered
 - Indirect carbon costs:
 - should it be compensated & how? More harmonisation?
 - give away free allowances or use auctioning revenue?
 - Support for innovation:
 - creating funds may not be enough
 - what should the scope of support be?

Summary of May 6 discussion

- Other elements to consider:
 - Trading phases: how long should they be, or should they even be discontinued?
 - Adjustments to the scope of the EU ETS
 - Different reduction paths for power and industrial sectors, reflecting different abatement potential
 - How will an international agreement affect carbon leakage risk – or alternatively, the LRF over time
 - Activation of ‘dormant’ ETS provisions
 - Possibility for border carbon adjustments (or inclusion imports in ETS)
 - Art 24a on domestic projects

The Impact Assessment

- Overview:
 - Summary of March public consultation
 - 2.2 Linear Reduction Factor implementation
 - Auctioning share to remain at the current level of 56% for phase 4 as well
 - Free allocation & carbon leakage
 - Benchmarks
 - Production levels and their updates
 - New Entrants Reserve
 - Indirect carbon cost compensation
 - CL groups and criteria
 - Low-carbon funding mechanisms
 - NER 300
 - Modernisation Fund

IA: total allocation

- The overall pie of allocation is decreasing over time due to the linear reduction factor
- The EUCO wants to keep the shares for auctioning and free allocation at the same levels (#2.9)
- Our assessment:
 - If the 2.2 LRF is implemented and the auctioning share remains the same, then total free allocation will go down over time; this may result in competitiveness problems in the long run
 - Ultimately, if you want to maintain free allocation at fully compensatory levels, the free allocation share will ‘eat’ into other shares:
 - The auctioning share will become smaller
 - Some of the budget for emissions under the ESD is transferred to the ETS
 - Compensation is sought outside EU framework -> international credits

Figure on...

EU Emissions

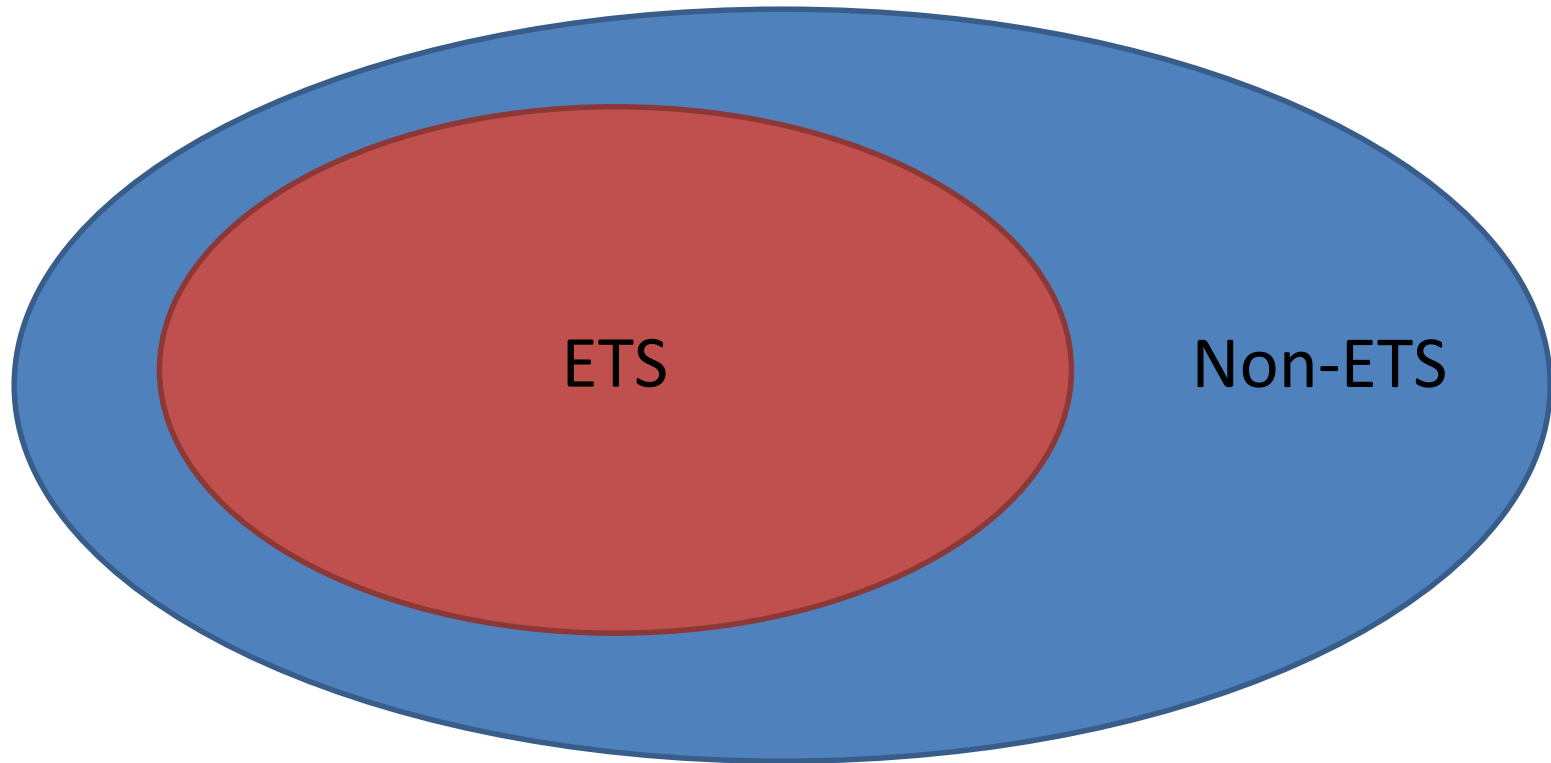


Figure on...

EU Emissions

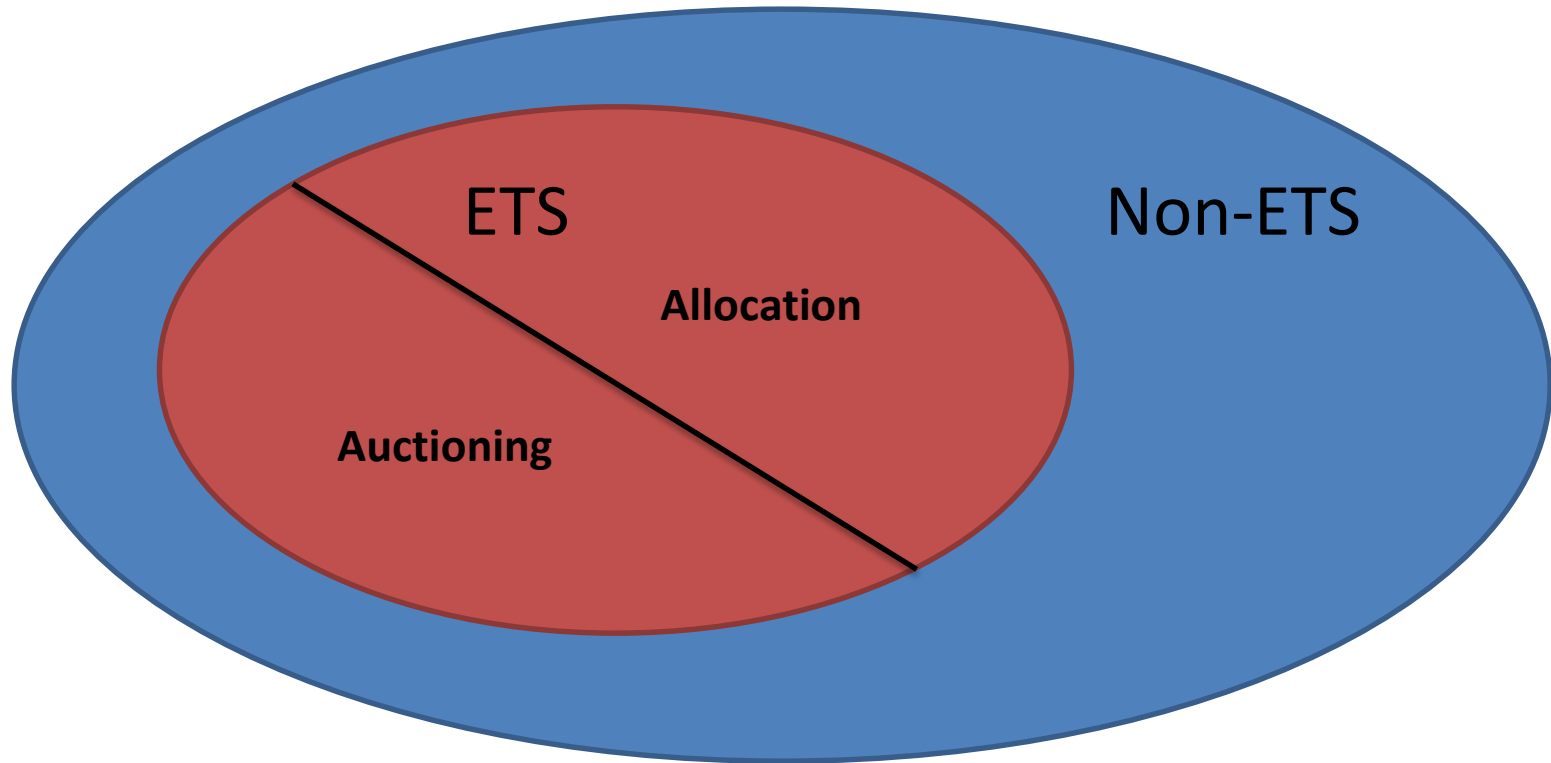
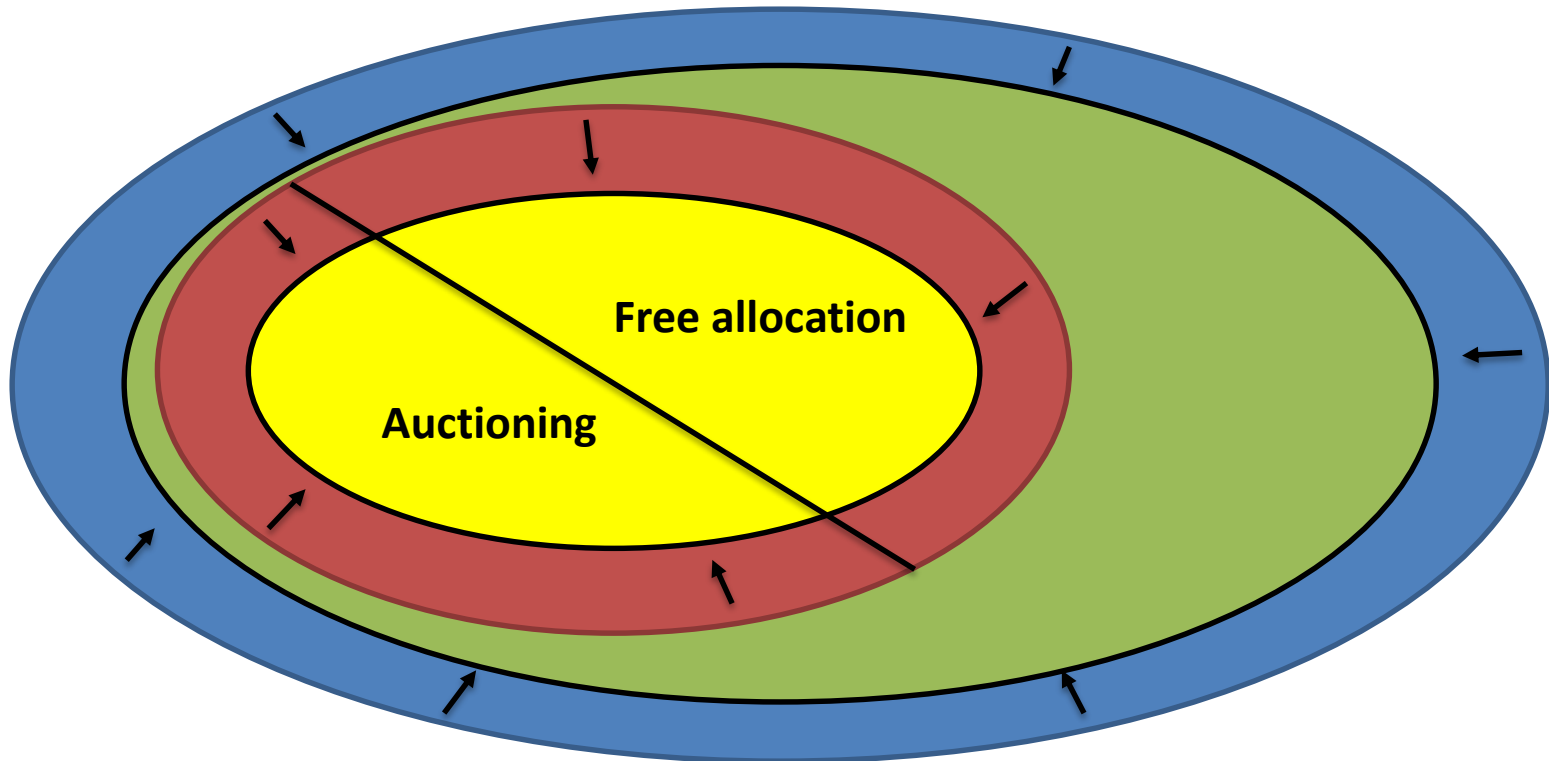


Figure on...

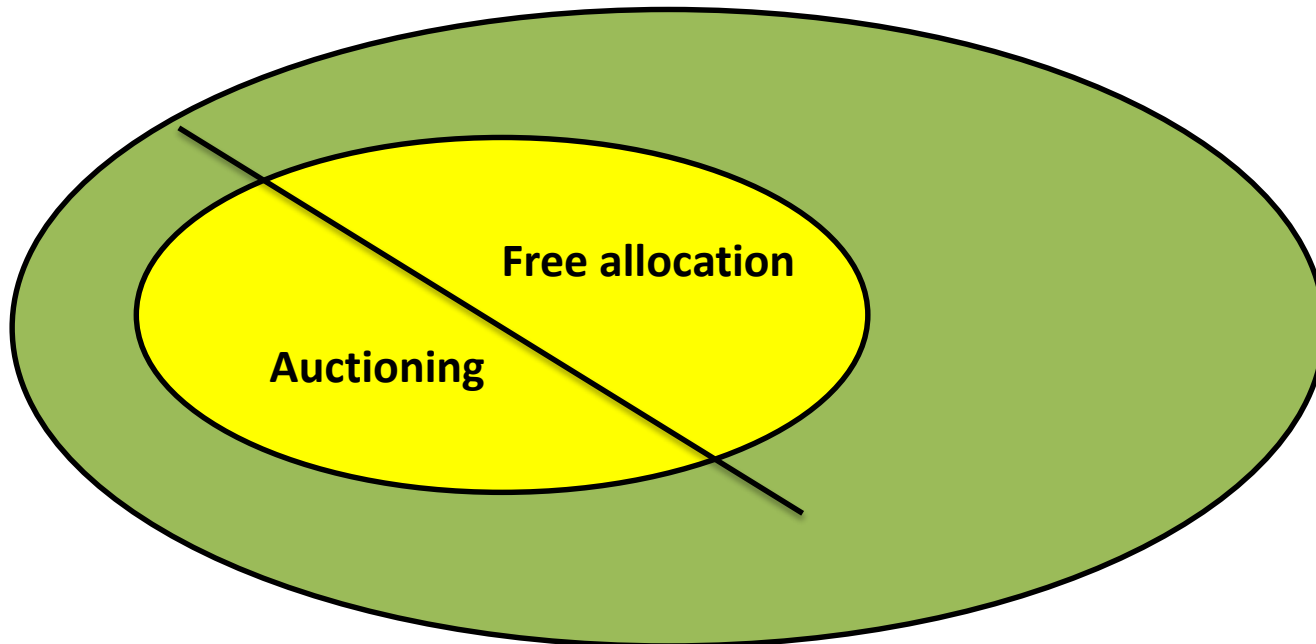
EU Emissions



Over time: EU emissions decrease, both for ETS and non-ETS sectors
 This leads to a decrease in the absolute number of allowances to be allocated

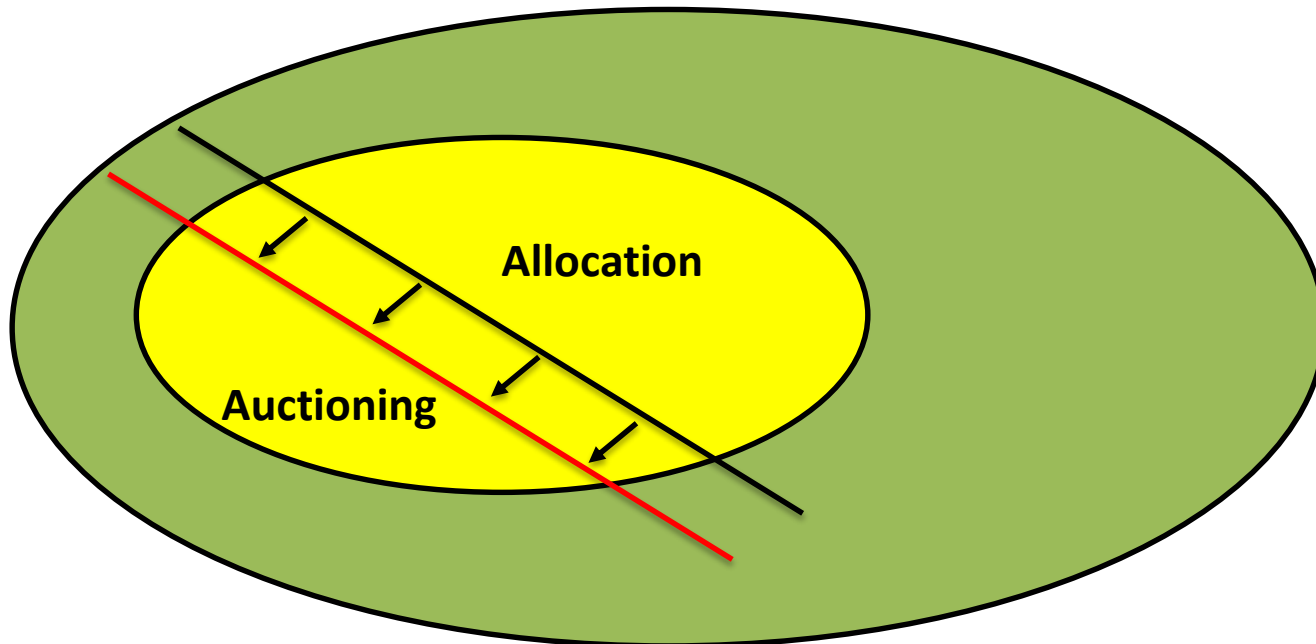
Figure on...

EU Emissions

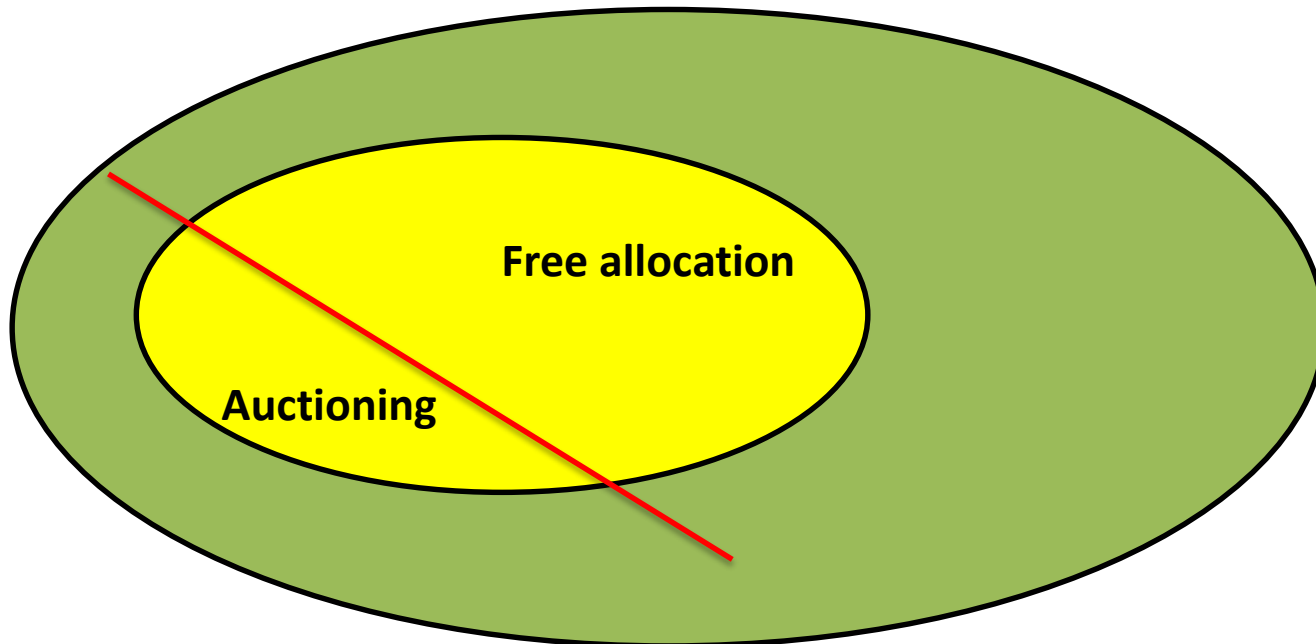


Option 1: increase allocation, decrease auctioning

EU Emissions



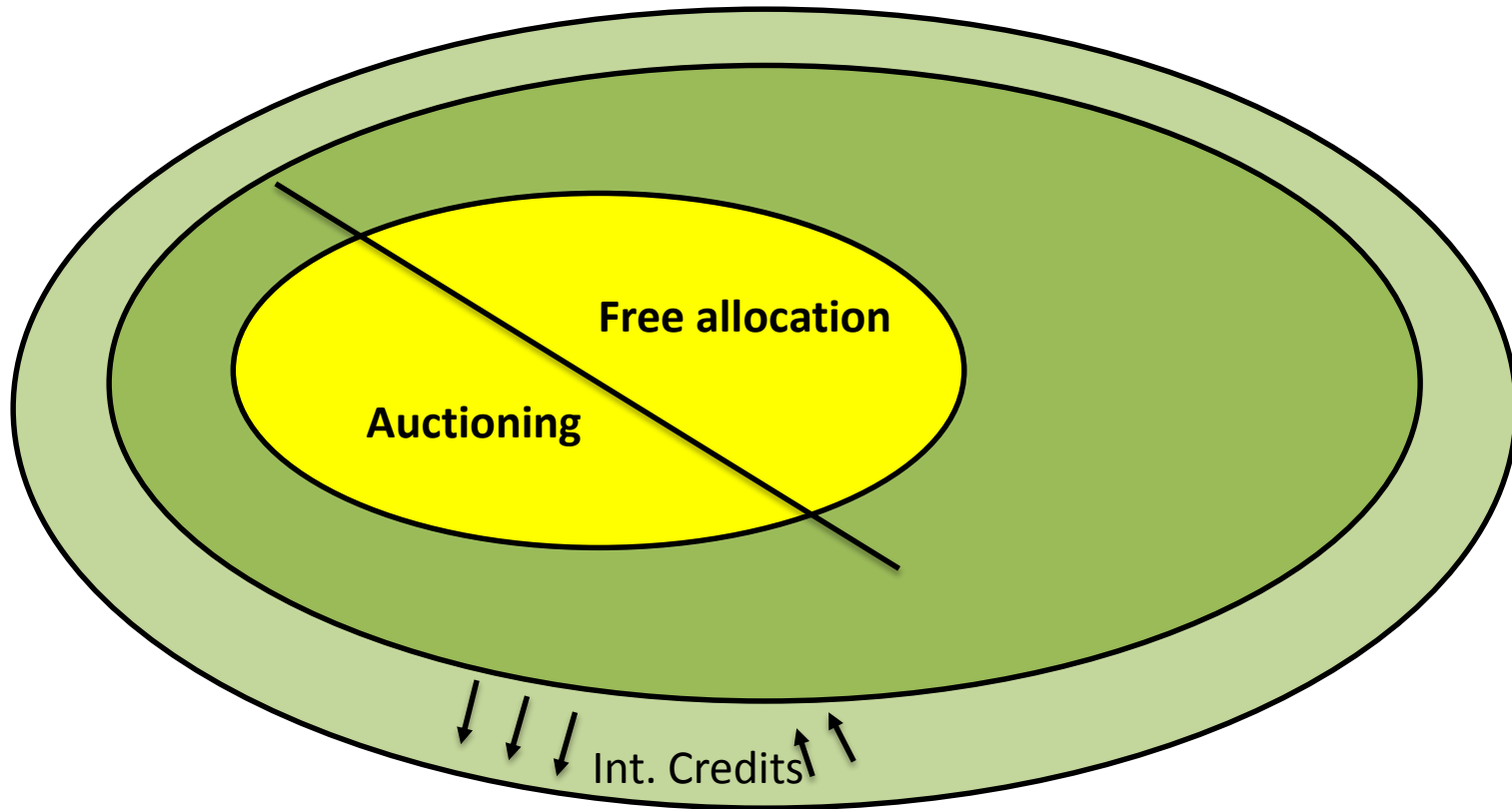
Option 1: increase allocation, decrease auctioning EU Emissions



Share of allowances in EU ETS that is allocated increases, share of auctioned allowances decreased

Option 2: use international credits

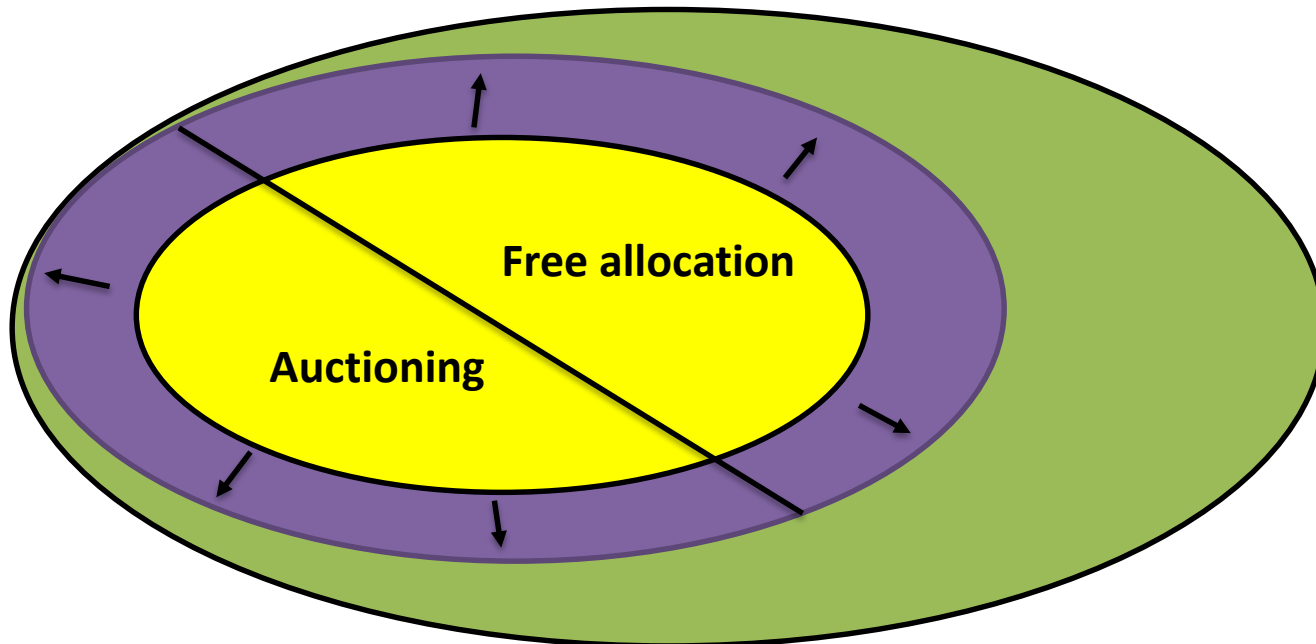
EU Emissions



Cap is increased

Option 3: ESD transfer to ETS

EU Emissions



Effort is moved to non-ETS sector

IA: Free allocation & carbon leakage

- Benchmarks: options under consideration
 - Baseline A: existing values – no updates
 - Baseline B: recalculate once before 2021 and keep constant afterwards
 - Option 1: all BM reduced once by same % reflecting average relative decrease in emission intensity
 - Option 2: BM values decrease at fixed intervals at a pre-defined rate (reflecting average relative decrease in emission intensity)
 - Option 3: recalculate once based on actual data + decrease at pre-defined rate
 - Option 4: BM are updated and kept constant at 5-year intervals

IA: Free allocation & carbon leakage

- Benchmarks options: our views
 - The baseline options would not reflect technological progress very well and would leave the benchmark question hanging
 - Using actual data for updates would also be more accurate than by basing it on averages in emission intensity changes
 - The continuous decreases in Options 2+ 3 create increased stringency over time, but the exact impact would be uncertain. On the other hand, such a system is probably easy to implement.
 - Option 4 benefits from accuracy while maintaining some certainty over time, but it requires a significant administrative effort

IA: Free allocation & carbon leakage

- Production levels & adjustments: options under consideration
 - Baseline A: current system
 - Baseline B: production levels defined once as the average of five baseline years (2014-2018) for the entire period. Same rules for production changes (only downward)
 - Option 1: 2014-2018 average as new baseline; updated rules for production changes accounting for both increases and decreases – 15% threshold assumed, NER used for increases in production
 - Option 2: Baseline defined twice in phase: average of 2014-18 for first 5-year period and then 2019-23 for second 5-year period – symmetrical rules for production changes as in option 1 (15% threshold)

IA: Free allocation & carbon leakage

- Production levels & adjustments: our views
 - The baseline options leave all the imperfections of the current system in place and do not seem to reflect EUCO Conclusions well
 - New system for production changes in Options 1 and 2 allows for increases in production, but as it is annual adjustments there will always be a delay
 - Increased production to be covered by allowances from NER, but as this is a limited quantity, what happens if NER would be empty?
 - Threshold also plays a very important role: if the threshold would be much lower than the assumed 15%, method approaches dynamic allocation
 - Gaming is in principle a risk, even if this is alleviated by using averages in baseline years

IA: Free allocation & carbon leakage

- Carbon leakage groups & criteria: options under consideration
 - Baseline A: uniform carbon leakage factor of 30%
 - Baseline B: current system
 - Option 1: uniform carbon leakage factor of 90%
 - Option 2: binary system but with criteria for emission and trade intensity regarded in combination (*inconsistency in footnote)
 - Option 3: gradual system: 4 groups with different levels of compensation, based on thresholds related to trade and emissions intensity (very high 100% / high 80% / medium 60% / low 30%)
 - Option 4: similar gradual system as option 3, but with more continuous, step-less thresholds
 - Option 5: carbon leakage factor equal to pass-through rates

IA: Free allocation & carbon leakage

- Carbon leakage groups & criteria: our views
 - A future system for determining carbon leakage risk should always consider trade and emission intensity in combination
 - Gradual systems seem a good option as it allows for free allocation to be more targeted
 - Option 3 while having some ‘cartesian’ simplicity, also has the downside that minor changes in scores for the risk criteria can result in a sector being placed in a different group, which has major consequences. This speaks in favour of step-less thresholds as in option 4.

Free allocation: other options to be considered

- Dynamic allocation
 - Method 1: apply a correction factor
 - Method 2: use a compensating reserve
 - Method 3: make the auctioning share the delta
- 100% auctioning – ex-post financial compensation instead

IA: Indirect carbon cost compensation

- The IA acknowledges that the current system has downsides, nevertheless, some option packages still include continuing with the current state aid based compensation regime
- Options under consideration:
 - Baseline: current state aid-based system – harmonised rules for awarding the aid, including that compensation be tapered
 - Option 1: compensation through auctioning revenues, with EU harmonised rules – formula similar to baseline
 - Option 2: compensation through free allowances, formula similar to baseline
 - Option 3: compensation through free allowances + maintaining option for MS to award state aid

IA: Indirect carbon cost compensation

- Options for indirect carbon cost compensation: our views
 - Any option involving state aid practices inherently has the problem of being discretionary, unpredictable and potentially distortive in the internal market
 - Compensation could be 100% to the indirect carbon costs incurred, but the clauses on ‘operating aid’ in state aid guidelines prevent this
 - Option 1, while being called a Mandatory Union system amounts to a system where MS pay (through loss of auctioning revenue) – no EU resources are involved

IA: innovation funds

- Options under consideration:
 - Baseline + alternative baseline: either continuing current rules or leave the Directive unchanged (support would be ceased)
 - Option 1: industry eligibility determined on % improvement over BM + replicability; 75% of costs may be covered; conditionality based on milestones in construction + operational performance
 - Option 2: not based on financial award/grant but on financial instruments, such as guarantees, loans, equity
 - Our views: the adapted elements (75% costs & disbursement during construction) of option 1 seem sensible, as innovation funds should remove as much as possible hurdles for private investors