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Position Paper

Eurogas initial reaction to the legislative proposal to reform the EU Emissions Trading System

Eurogas is the association representing the European gas wholesale, retail and distribution sectors. Founded in 1990, its members are 44 companies and associations from 24 countries.

Eurogas represents the sectors towards the EU institutions and, as such, participates in the Madrid Gas Regulatory Forum, the Gas Coordination Group, the Citizens Energy Forum and other stakeholder groups.

Its members work together, analysing the impact of EU political and legislative initiatives on their business and communicating their findings and suggestions to the EU stakeholders.

The association also provides statistics and forecasts on gas consumption. For this, the association can draw on national data supplied by its member companies and associations.

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Background

On 15 July 2015, the European Commission (EC) released a legislative proposal for the reform of the Emission Trading System (ETS) entitled "*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*". The draft legislation maintains the existing architecture of the ETS, while at the same time proposing modifications under three main strands, namely:

- an increase in the linear reduction factor (the annual rate of reduction in ETS allowances);
- a more targeted allocation of free allowances to the industrial sector;
- the introduction of two new funds, an innovation fund for all Member States and a modernisation fund for 10 Eastern European Member States.

The ETS is the cornerstone of the European Union's policy to fight against climate change and this reform is necessary for the ETS to play its full role in reducing greenhouse gas (GHG) emissions cost-efficiently. Eurogas therefore welcomes the legislative proposal by the EC, recognises that it is aligned with the European Council conclusions of October 2014 and believes that overall it takes a balanced approach, although Eurogas would have preferred an approach having an earlier impact on the functioning of the ETS.

The linear reduction factor

The proposal contains an increase in the linear reduction factor from the current 1.74% to 2.2%, to apply from 2021 onwards. This is the factor that reduces the amount of emission allowances available each year for the ETS sector and is the level for ensuring that the overall reduction target of minus 43% GHG emissions for the ETS sector is met by 2030. The underlying overall target of a 40% GHG emissions reduction by 2030 is the minimum level required in order for Europe to be in line with the agreed objective of an 80–95% reduction of GHG emissions by 2050.

- ***The proposed new linear factor of 2.2% for the ETS sectors from 2021 is necessary to put Europe on track towards a 40% GHG emissions reduction target.***
- ***The linear reduction factor should be increased earlier than 2021 in order to smoothen the path to the 40% target in 2030 as well as the transition from phase 3 to phase 4.***

Share of auctioned allowances

The EC proposes that the share of allowances each year for *auctioning* is set at 57% of total allowances over the fourth trading period (2021-2030), with the remainder being used for *free allocation*[1]. We understand that this ratio is based upon the average share of allowances for each of the two groups (auctioned and free allowances) for the third trading period. Up to 2020, the amount of allowances for auctioning is derived after the free allocations for certain

[1] The allowances for the modernisation fund are to be sourced from the 57% portion of the ETS, while 400 million allowances for the innovation fund will come from the 43% portion. A further 50 million allowances for innovation will be taken from the market stability reserve (MSR).

industries are calculated and subtracted from the total available. Thus, this existing approach leaves a considerable element of uncertainty for market participants trading ETS allowances. The proposed change to fix the share of auctioning and free allocation seems a fair and balanced approach. It gives certainty to the carbon market participants, while also ensuring a greater amount of free allocation to industry than would be the case without this reform.

- ***The proposal of an explicit share of allowances of 57% for auctioning is fair to both groups and is necessary to provide certainty of the volumes to be auctioned in the ETS.***

Funds

The innovation fund in the legislative proposal is an expansion of the previous NER300 fund, which offered support for renewable energy sources (RES) and carbon, capture and storage (CCS) developments. The new fund will also include funding for industrial innovation. It is based on an increased total of 400 million allowances becoming available from 2021, and a further 50 million allowances will be available before 2021, sourced from unallocated allowances placed in the Market Stability Reserve (MSR). However, the legislation provides no limitations on when the funds can be utilised over the trading period, meaning theoretically the whole 400 million allowances could be sold to the market in one calendar year. This introduces significant uncertainty to market participants.

A modernisation fund of over 300 million allowances is also proposed, which will be available for 10 Eastern European Member States in order to modernise their energy system. The October 2014 Council conclusions stated that the current modalities, including transparency, should be improved to ensure that the funds are used to promote real investments modernising the energy sector, while avoiding distortions of the internal energy market. The proposal adds more safeguards for the governance of the modernisation fund. It also sets out parameters for Member States to follow, when selecting the investments to be financed with free allocation, though it is not prescriptive on the nature of investments themselves. As is the case with the innovation fund, there is little restriction on when the funds could be utilised over the trading period.

- ***The innovation and modernisation funds are positive inclusions, as is the addition of funding for industrial innovation.***
- ***For both funds, the amount of allowances that can be utilised in any one year should be limited, to avoid large market distortions.***
- ***Further clarification on the use of the modernisation fund should be set out, in order to ensure that it is used in a transparent manner. It should be used for its intended purpose, which should be to decarbonise the energy system in a cost-effective and technology-neutral manner.***

Carbon leakage measures

The measures for carbon leakage are more targeted and reflective of actual production, which is necessary with the total amount of emission allowances falling year-on-year and in order to avoid over-allocation to any sector. The introduction of the above mentioned innovation fund for industry and a more flexible New Entrants Reserve (NER) are also measures to address this issue.

- ***The goal for the EU should be an international agreement whereby the EU's trading partners make an equivalent effort, meaning that carbon leakage measures will no longer be needed. As long as the EU's international trading partners do not make equivalent efforts to reduce GHG emissions, carbon leakage will remain an important issue and free allocation to affected industries will be needed.***

- ***The EC proposals to target carbon leakage measures to those industries that need them and make the allocation of free allowances more reactive to actual production are welcomed.***

The existing rules allow for Member States to compensate industry for indirect carbon leakage costs. These are costs that arise as a result of increases in electricity prices due to the costs of carbon incurred in electricity generation. Currently, not all Member States make use of this option. The new proposal does not harmonise or oblige Member States to cover this cost, but the language is strengthened from a “may” obligation to a “should” obligation to adopt financial measures due to significant indirect costs. The obligation of Member States to ensure any compensation is in line with the state aid guidelines for energy and the environment remains.

- ***Support for indirect carbon leakage should continue to be in the form of financial measures rather than through free allocation.***
- ***Ideally, further European guidance on the approach for how Member States compensate for indirect carbon leakage would be useful.***

New Entrants Reserve

A NER comprising approximately 400 million allowances (250 from the MSR and the remainder from unallocated allowances) is proposed. Its use would be no longer limited to additional production capacity but also increases in actual production, which is aimed at protecting industry against carbon leakage.

- ***Eurogas cautions against using allowances from the MSR for the purpose of the NER, as the Market Stability Reserve was established with the intention of addressing the very large surplus of existing allowances.***

International credits

The proposal does not provide for the use of new international credits. The experience with such international credits in implementing the 2020 policy framework was disappointing, as the ETS was flooded with allowances, one of the key reasons prices have been depressed for some time. The quality and consistency of international credits that were used also varied considerably.

- ***The EU should allow for the use of international credits, if it seeks to go beyond a 40% GHG emissions reduction target. Such an additional commitment should depend on other international partners making meaningful emission reduction efforts. Any such measure***

should be carefully designed to prevent the experiences of previous use of international credits.

- ***Furthermore, it would help to make the ETS compatible with emissions trading systems outside Europe.***

Additional Comments

The benchmark for industrial boilers was not derived in the same manner as other industrial benchmarks, which are based on the best 10% performing installations. Instead, it is based on a defined “heat benchmark” which is a specific number, calculated from a defined efficiency of a boiler using natural gas. This defined efficiency parameter is at the higher end of the efficiency spectrum. Therefore, the application of the proposed annually strengthening of the benchmark by at least 0.5 % would drive the benchmark well over technically possible efficiencies.

Under the current legislation, the free allocation for the heat element of cogeneration is subject to the linear reduction factor directly, rather than through the cross sectoral correction factor (CSCF). The new legislative text proposed for Article 10.a.5 reduces clarity on how CHP is treated in terms of the application of both reduction factors and may risk being punitive towards CHP.

- ***Technical progress in industrial boilers should be addressed separately and not by an automatic strengthening of the benchmark.***
- ***The proposal should not deteriorate the treatment of CHP under the ETS.***