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Argus White Paper

Review of the EU Emissions Trading Scheme (ETS) Directive

The process

The creation of EU laws begins with a proposal from the European Commission. This is evaluated and amended in parallel processes by the European Parliament and the EU Council. The parliament assigns competence over the reform to one particular specialist committee — the environment committee in the case of the review of the emissions trading scheme (ETS) directive. Committee amendments are voted on by the parliament as a whole. Parliament's industry committee can make advisory amendments, but the environment committee can ignore these.

Meanwhile, a technical working group in the council examines the same proposal by the commission. Changes are agreed and then signed off by EU environment ministers. The council, parliament and commission then begin three-way discussions to agree a text acceptable to all parties. This compromise text then requires approval from the council and the parliament

The European Commission proposal

The commission made recommendations for the governance of the ETS in phase four, covering 2021-30, in its proposal published in July 2015. These fell into three key areas — overall climate ambition (defined by the tightness of the emissions cap), carbon-leakage proposals and support mechanisms.

Cap

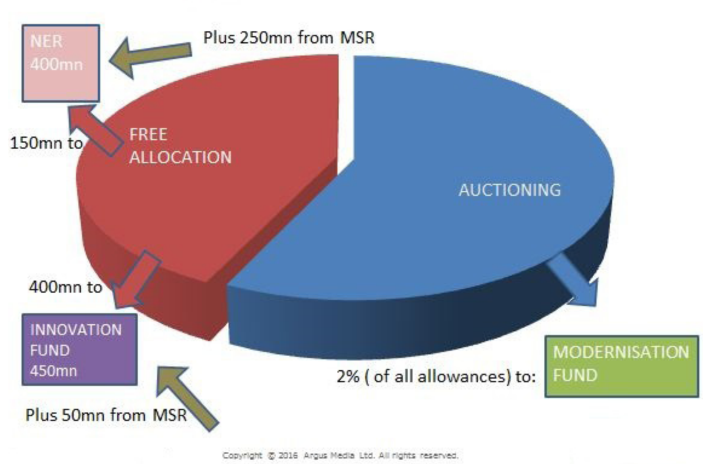
The commission proposed that the linear reduction factor (LRF) for the cap should be reduced by 2.2pc/yr from 2021, compared with from 1.74pc/yr now. A fixed 57pc of the total amount of emissions allowances will be auctioned, with the remaining allowances available for free allocation.

Carbon leakage

The basic architecture of free allocations will remain. Under this system, the exposure of various sectors to the dangers of carbon leakage – where production of goods and services moves, or "leaks", from regions with emissions regulations to those without – is mitigated by the distribution of free ETS permits.
The changes in phase four will revolve largely around how the exposure of various sectors is measured and how the free permits are allocated. The commission proposal revises the system to focus on sectors facing the highest risk of carbon leakage — around 50 in total. It sets aside a larger number of free allowances for new and growing installations, introduces more flexible rules to better align the amount of free allowances with production figures, and updates sector benchmarks – against which the emissions performance of installations are judged – to reflect technological advances.

Support mechanisms

An innovation fund of 450mn allowances is proposed for low-carbon investments with high capital costs and a modernisation fund will help finance modernisation of the power and energy systems in the 10 lowest-income member states.



The most significant amendment proposed by the industry committee was the further tiering of free allowances to better target their distribution. It suggested removing lesser-exposed sectors from the carbon-leakage list and grouping the remaining sectors into four tiers. This could create as many as 886mn spare allowances in phase four, according to some analysts.

Environment committee changes to commission proposal

Cap

The draft opinion proposed that the LRF should be kept at 2.2pc/yr until 2022, but then changed to reflect the ambition of the UN climate agreement reach in Paris last year, once that ambition has been calculated and quantified after the first global stocktake in 2023. As part of its annual review of the functioning of the ETS, the commission should consider the impact of overlapping EU polices and, if necessary, make a proposal to the parliament and the council to address the issue, the environment committee suggested. And it proposed that member states should have the option of cancelling allowances added to the surplus as a result of domestic emissions mitigation that was not driven by the ETS.

Carbon leakage

The committee proposed a slightly more focused distribution of free allowances than the commission, with four tiers of exposure determined by a sector's ability to pass on carbon costs to its customers.

It would introduce a new benchmark reduction rate of 0.3pc to account for industries that cannot achieve the standard reduction of 0.5pc/yr in the commission proposal and, although it keeps the 57pc share of allowances for auction proposed by the commission, it would reduce this share by up to two percentage points if the cross-sectoral correction factor (CSCF) were triggered, to increase the free allowance share — the CSCF is triggered if, after the benchmark calculations are carried out, the number of free allowances to be allocated exceeds the 43pc ratio.

The environment committee proposed a more dynamic type of allocation, corresponding to a 10pc increase or decrease in the production of an installation, compared with 50pc now.

Support mechanisms

The committee proposed increasing the size of the innovation fund to 550mn allowances, with half coming from the phase-four auction share and half coming from phase-four free allowances.

And it fine-tuned the rules for applying for finance, changing the thresholds so that the funds are more likely to be channelled to larger, more capital-intensive projects, than to a number of smaller projects, and widening the focus on carbon capture and storage to include carbon capture and use (CCU) projects.

The council discussion on the commission proposal

Cap

There was consensus in the council on the 2.2pc/yr LRF, many supported the 57pc fixed auction share and several suggested a more tiered approach to carbon leakage.

Carbon leakage

Some delegations argued that they could support an approach with three or more tiers only if an installation's location is taken into account, as well and its trade and emissions intensity, when evaluating its exposure to carbon leakage.

A number of delegations supported updating benchmark values twice in phase four, in 2021 and 2026. Several preferred that all benchmarks are recalculated before the start of phase four and should be based on recent verified data.

Support mechanisms

Delegations were generally supportive of the proposed scope and size of the innovation fund, and emphasised its strategic importance in enabling energy intensive industry to support low-carbon innovation. Most delegations favoured simplified procedures for smaller projects to enable a wide geographical spread. A number of delegations asked explicitly for funding to be available to CCU projects.

Price corridor

France proposed the introduction of a "price corridor" for the ETS by setting a reserve price at auctions. But this idea has failed to gain traction in the council and France will need the support of larger states, such as Germany, to push the measure through in the face of strong opposition from member states in eastern Europe.