CAN Europe's Position on the ETS Reforms

21 March, 2016

CAN

CLIMATE ACTION NETWORK

Europe

Climate Action Network (CAN) Europe is Europe's largest coalition working on climate and energy issues. With over 130 member organisations in more than 30 European countries - representing over 44 million citizens - CAN Europe works to prevent dangerous climate change and promote sustainable climate and energy policy in Europe.

Heading towards more 3^{o}C warming!

The [Stern Review] on the Economics of Climate Change, published in 2006, predicts that a rise of 3°C would mean 550 million more people would be at risk of hunger, 170 million could suffer coastal flooding and nearly half the world’s species could face extinction.

Impacts that different parts of Europe would experience in a 2C world, and it breaks those impacts down into different sectors - health, tourism, energy, agri, etc

https://www.atlas.impact2c.eu/en/

Paris is a call for action!

In the Paris Agreement all countries agreed to hold the temperature increase well below 2°C and furthermore to pursue efforts to limit it to 1.5°C.

Europe would have to reduce its emissions more than 95% below 1990 levels by 2050 to ensure a more than 50% chance to have no more than 1.5°C warming by 2100.

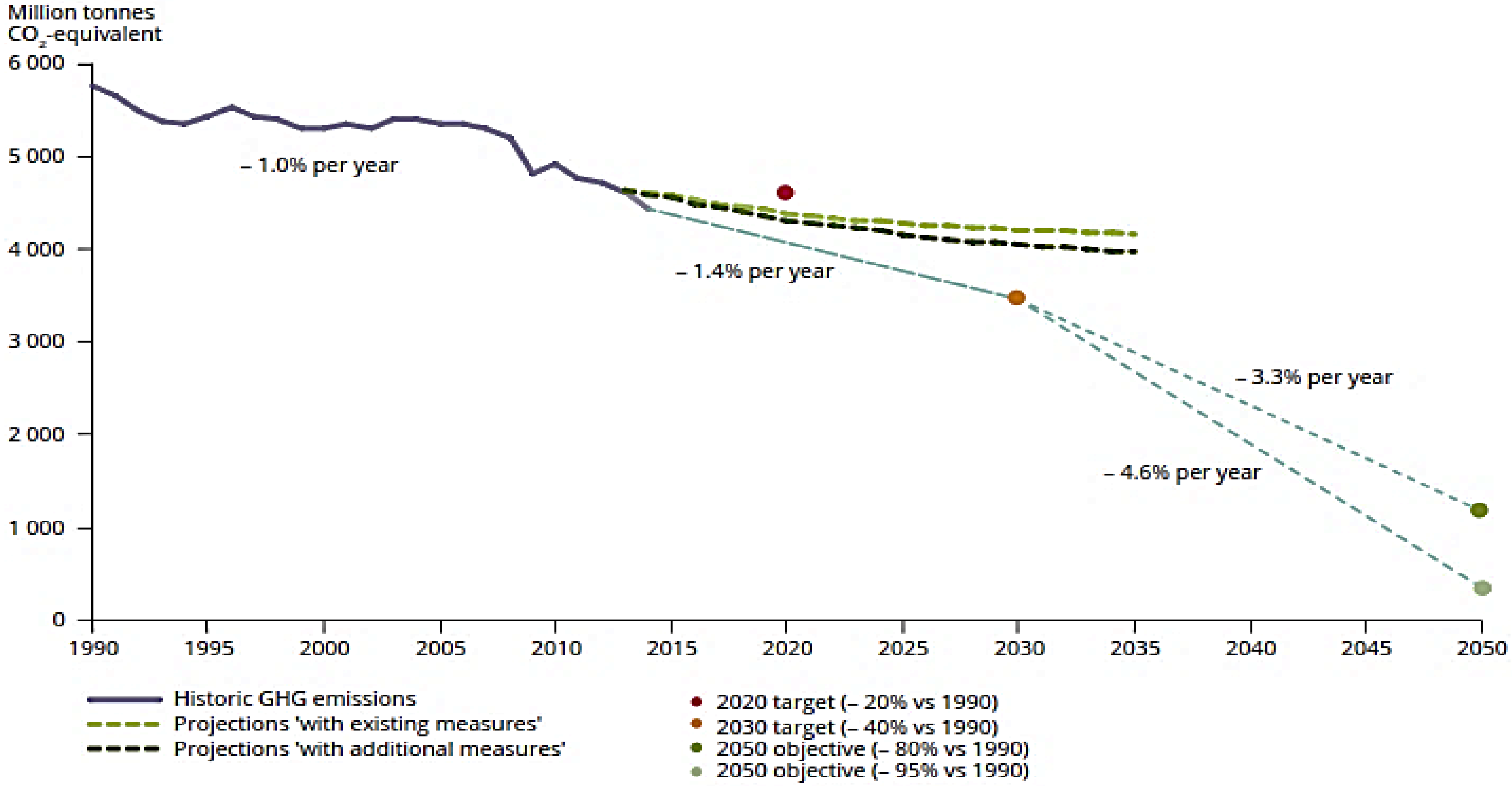
ETS target of 43% below 2005 emission levels would only lead to an 84% reduction in the ETS sectors by 2050.

→ ETS targets have to be raised significantly to ensure the EU lives up to its commitments under the Paris agreement, including to pursue to keep temperature rise below 1.5°C.

→ **The Comission proposal is weak and Member States show little appetite for substantial reforms.**

→ **It will be up to the Parliament to make the ETS more fit for purpose!**

EU greenhouse gas emission trends, projections and reduction targets



http://www.eea.europa.eu/publications/trends-and-projections-in-europe-2015

ETS is failing to deliver

A weak reduction target, the massive use of international offsets, and inflexible policy design have led – together with the economic recession

→ gigantic oversupply of allowances

→ price drop

→ no signal to lower emissions

The Market Stability Reserve (MSR) is an important but insufficient first step to improve the ETS. The surplus is only temporarily removed and models predict that the market will be oversupplied until 2025 or later.

What researchers and others say

Thomson Reuters Point Carbon: EU falsely claiming it's on a credible track to 2C Paris climate goal

A white paper points out that the European Commission's proposed post-2020 ETS review proposal falls short of putting the bloc on track to meeting its 2050 aim to cut emissions 80% under 1990 levels, a goal that has been calibrated to form the EU's contribution to meeting the 2C global temperature goal.

CEPS: "Cannot be right" that EU ETS is long while falling short of GHG goals

In its State of the EU ETS Report, CEPS said "it must be a concern" that the target does not seem to be in line with the bloc's 2050 emission goal of a 80-95% cut on 1990 levels. The report questioned whether the current focus over the share of freely-allocated carbon allowances and industrial competitiveness among stakeholders is overshadowing the long-term adequacy of the ETS in meeting environmental goals cost-effectively.

Barclays: Current EU climate targets mean €5 EUAs, little fuel-switching through 2030

Allowances will average €5 through all of the fourth phase of the EU ETS (2021-2030) under the bloc's current climate targets, meaning prices won't be high enough to incentivise Europe's biggest utilities to shift towards burning cleaner fuels until after 2030. The 2030 target is not sufficiently tight to make the EUA price an economic constraint on coal and lignite-fired generators.

France floats EU ETS price support proposal

France wants to introduce a "soft collar" for allowance prices because it says existing reforms fall short. The non-paper is intended to force EU lawmakers to face up to the reality that something further needs to be done to address low carbon prices, which remain depressed by a years-old surplus despite several rescue measures.

1. Making the ETS fit for purpose

1.1 Starting point for 2021 at actual emission levels

1.2 Permanent cancellation of allowances

1.3 Raising Linear Reduction Factor

1.4 Raise Target Every Five Years

1.5 No use of International offsets, ETS linking only under certain conditions

Starting point for 2021 at actual emission levels

The starting point for 2021 should be at actual emissions and not at the current minus 21% ETS target for 2020.

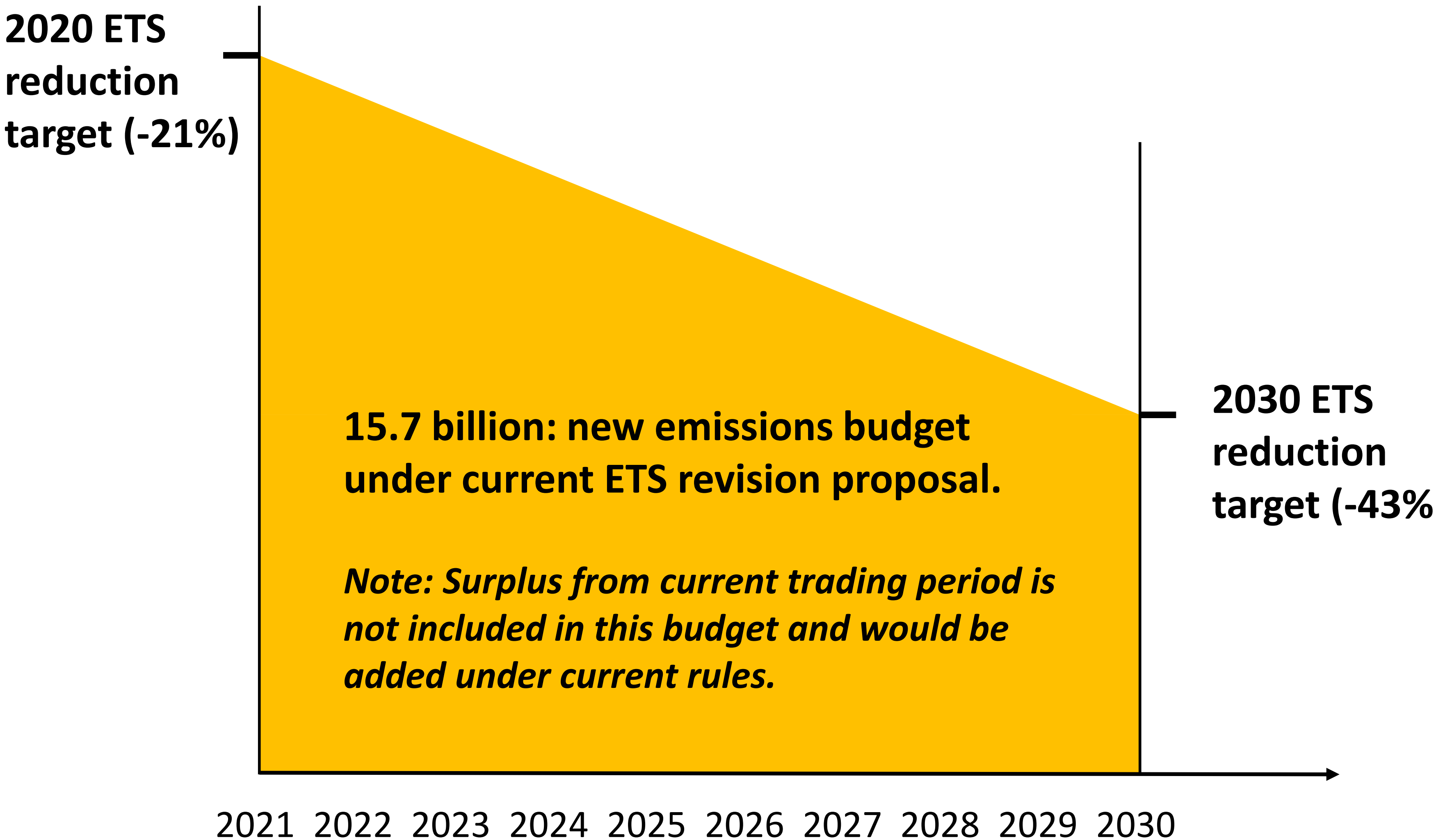
If the emissions will be, as projected, at minus 38% in the ETS sectors by 2020 starting at actual emission levels would significantly reduce total emissions under the ETS.

Please note that this measure would not eliminate the surplus from phase 3!

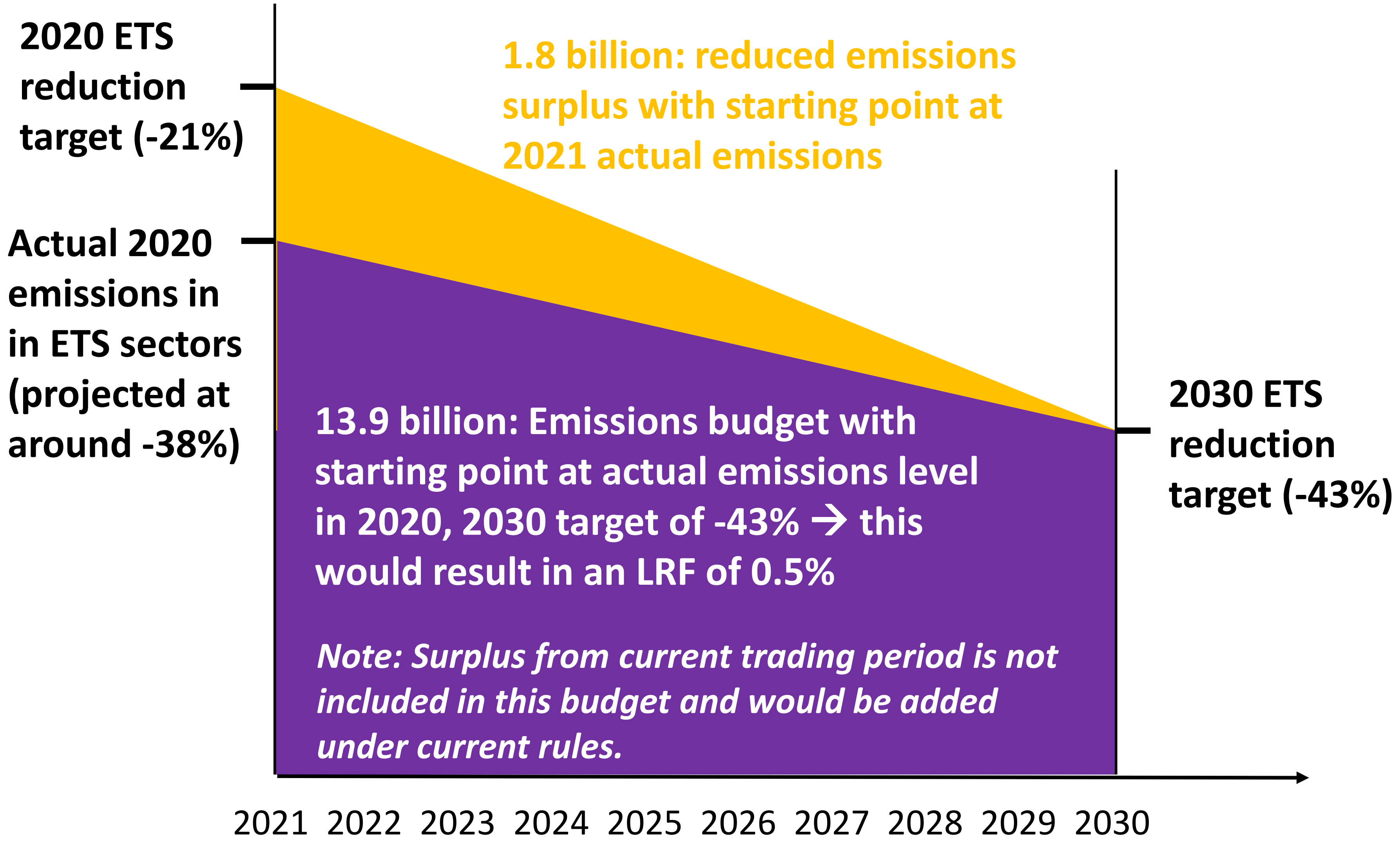
CAN EUROPE CALLS FOR

The starting point for 2021 to be at actual emissions and not at the ETS target for 2020 (21% below 2005 emissions).

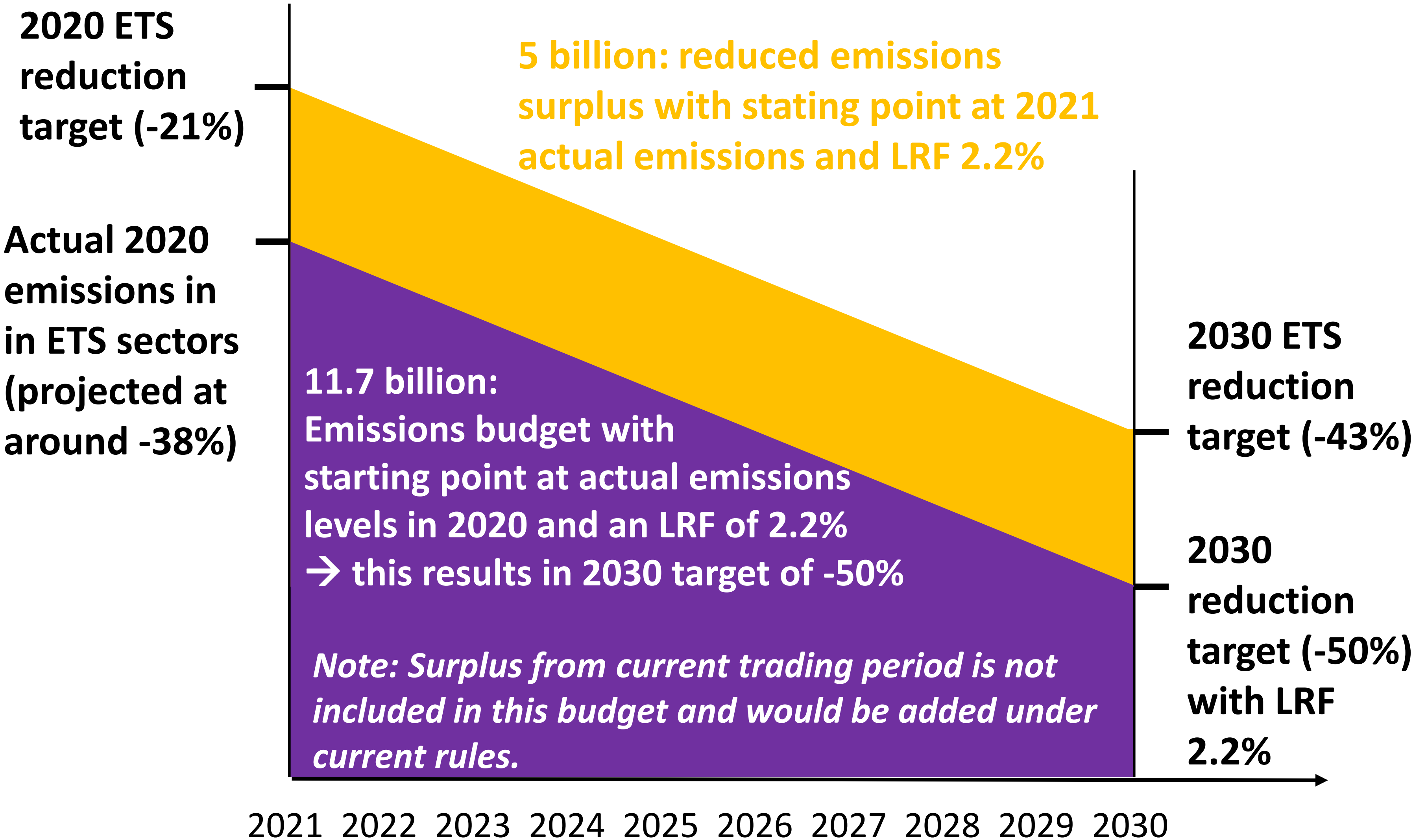
Starting Point:
Currently proposed emissions budget



Emissions budget: starting at actual emission levels



Emissions budget: starting at actual emission levels with Linear Reduction Factor at 2.2%



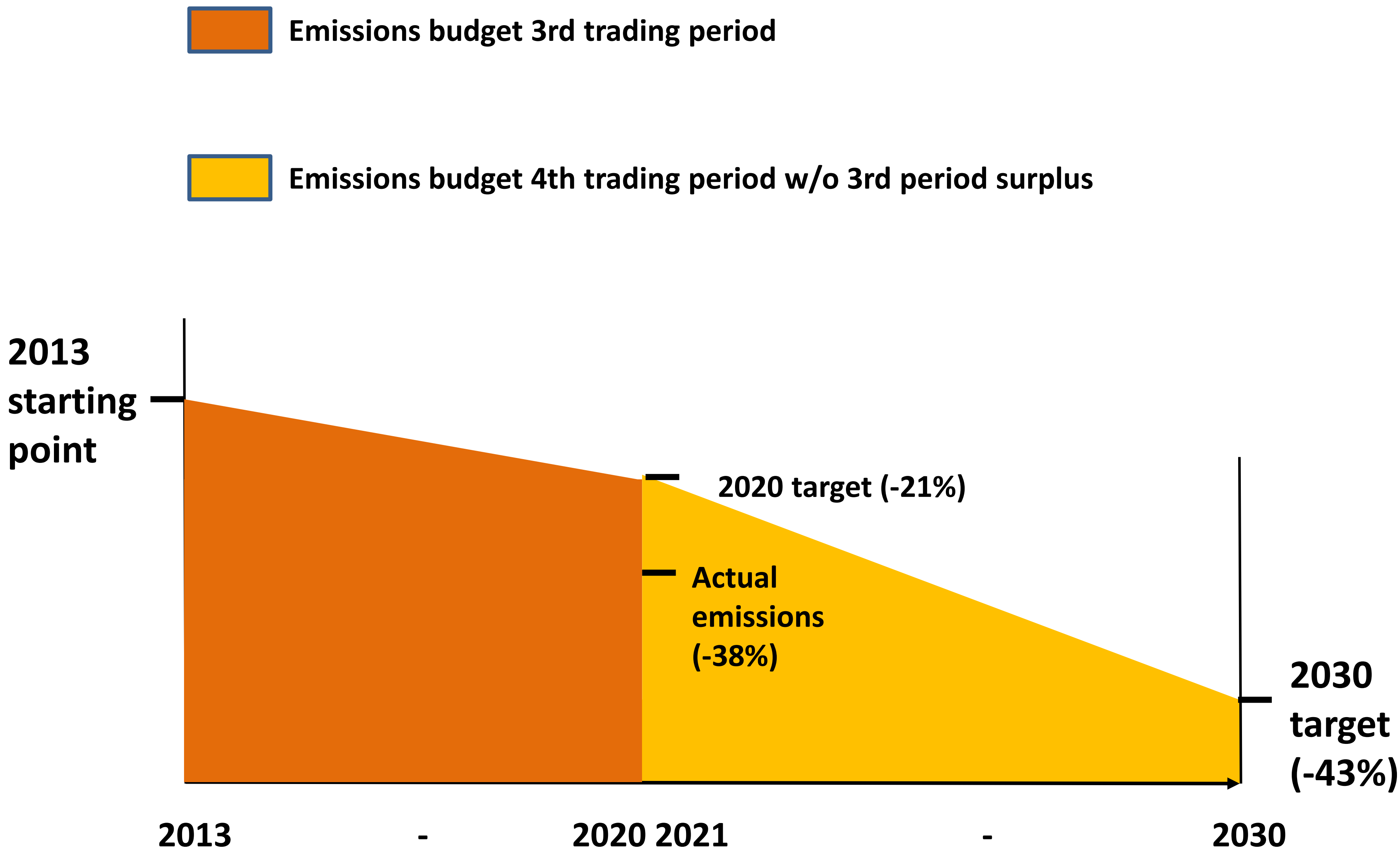
Permanent cancellation of allowances

By 2020 the ETS surplus will have grown to between 2.6 and 4.4 billion allowances.

The billions of surplus pollution permits that will have accumulated by 2020 can, under current rules, be fully carried over to the next trading period.

Scenario	Emissions budget 2021-2030 without estimated 4.4 billion surplus from phase 3	Emissions budget 2021-2030 with estimated 4.4 billion surplus from phase 3
Current proposal (start at 2020 target: -21%), LRF 2.2%	15.7 billion	20.1 billion
Actual emissions in 2021 (-38%), LRF 0.5%	13.9 billion	18.3 billion
Actual emissions in 2021 (-38%), LRF 2.2%	11.7 billion	16.1 billion

Why surplus from third trading period would be added under current rules independent of starting point and LRF for 4th trading period



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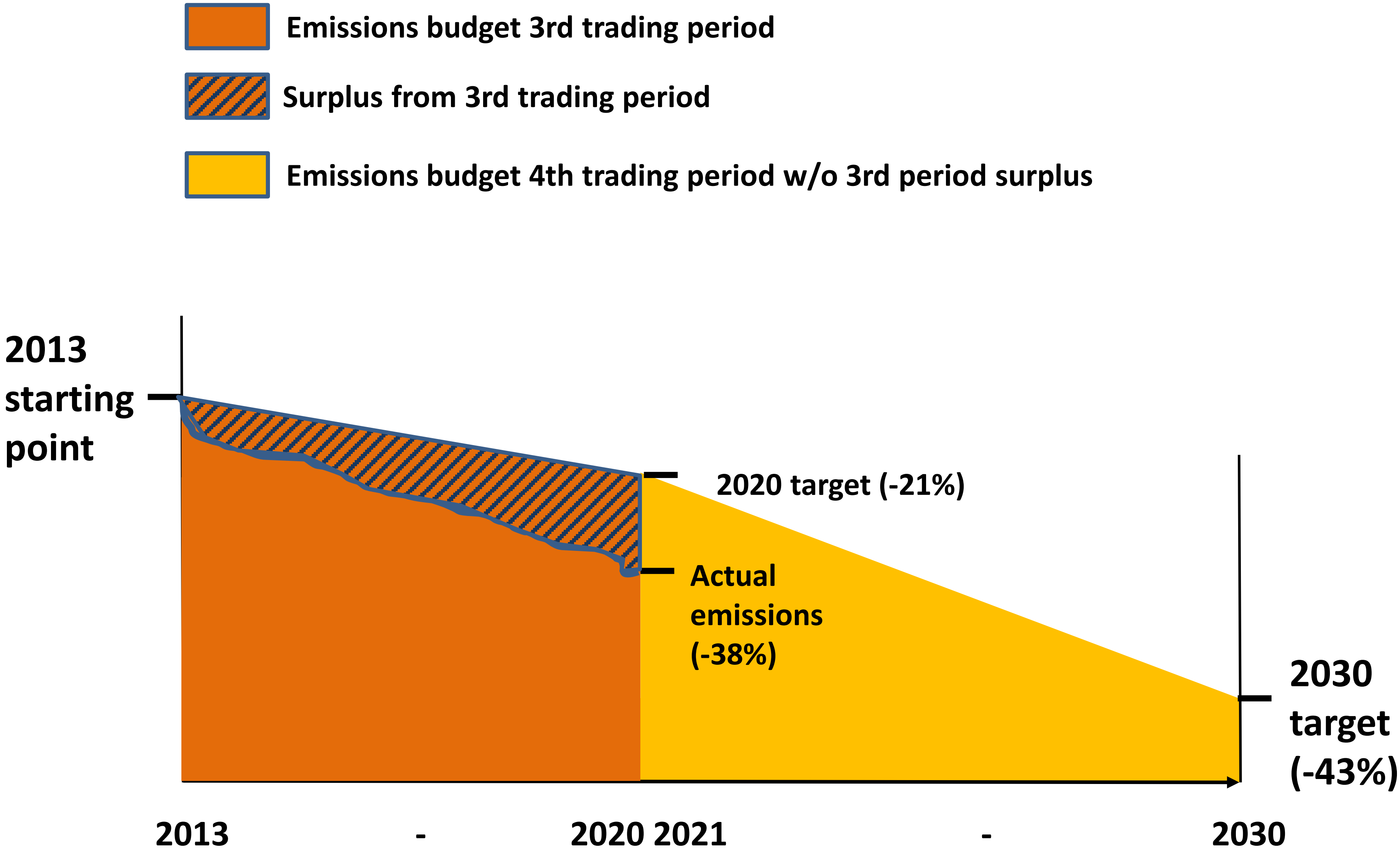

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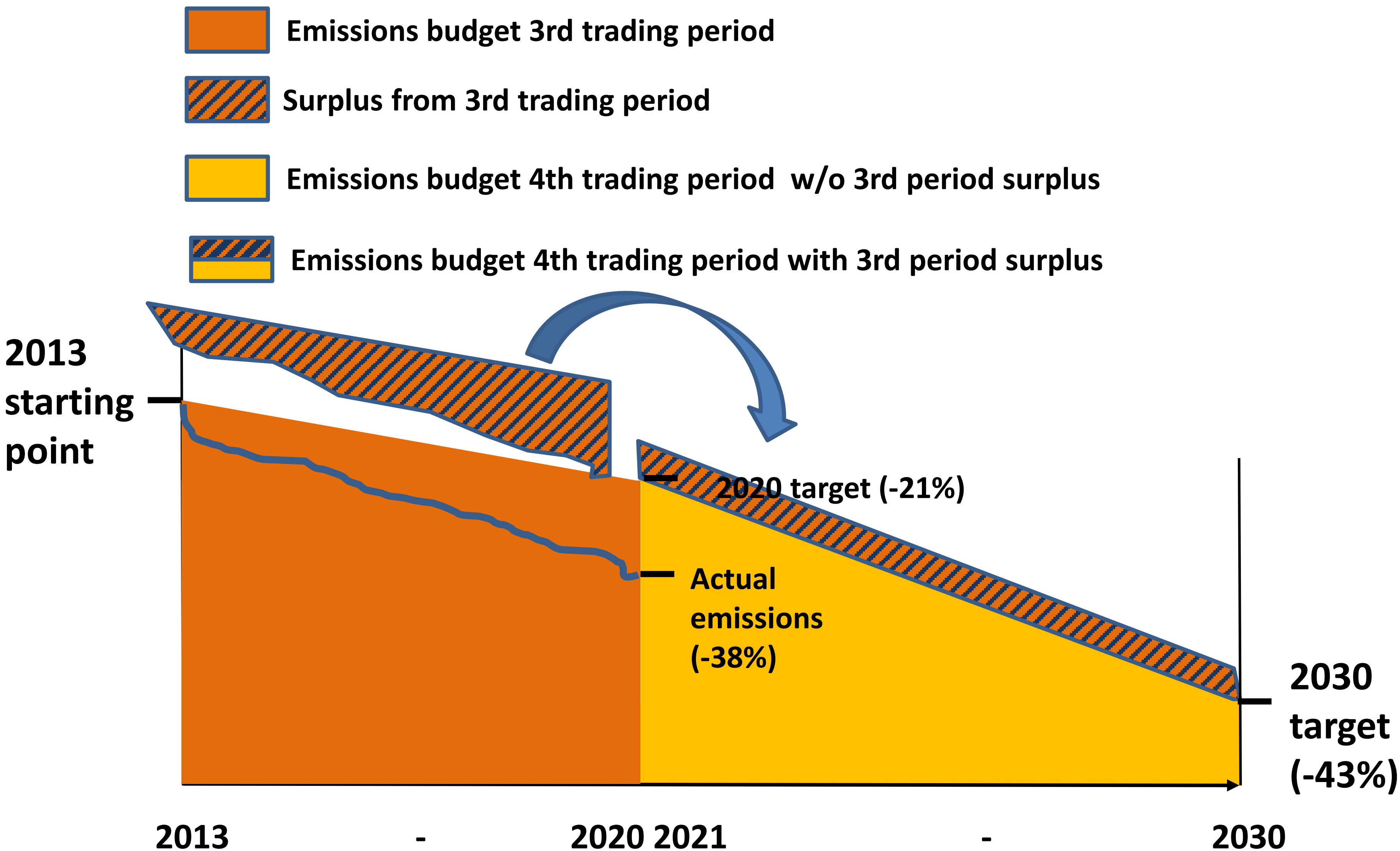


Permanent cancellation of allowances

CAN EUROPE CALLS FOR THE FOLLOWING MEASURES WHICH SHOULD BE COMBINED WITH EACH OTHER:

- **The permanent cancellation at the end of 2020 of around two billion surplus allowances that will have accumulated in the MSR by that point.**
- **A limit on the number of allowances than can be stored in the Market Stability Reserve (MSR).** To avoid a large accumulation of allowances in the MSR should hold a maximum of allowances equal to 50% of the total ETS allowances made available in a given year. Allowances in the MSR above this ceiling should be automatically cancelled.
- **A limit on the validity of allowances in the MSR.** Allowances that remain in the MSR for more than five years should be cancelled permanently. This provision would also ensure that the MSR does not grow to be very large.
- **Allowing the unilateral cancellation of allowances by Member States.** If individual Member States choose a higher mitigation target or other measures that raise their mitigation levels, they should be able to cancel allowances that would enable them to unilaterally raise the stringency of their target without just making it easier for other Member States to reach the overall EU target.
- **Allowances that remain in the new entrants reserve at the end of each trading period should be cancelled.** A second best option would be to put them into the MSR. The phase 4 new entrants reserve should therefore only be filled with allowances from phase 4.

Raising Linear Reduction Factor

The Linear Reduction Factor (LRF) determines by how much the number of available allowances are reduced every year.

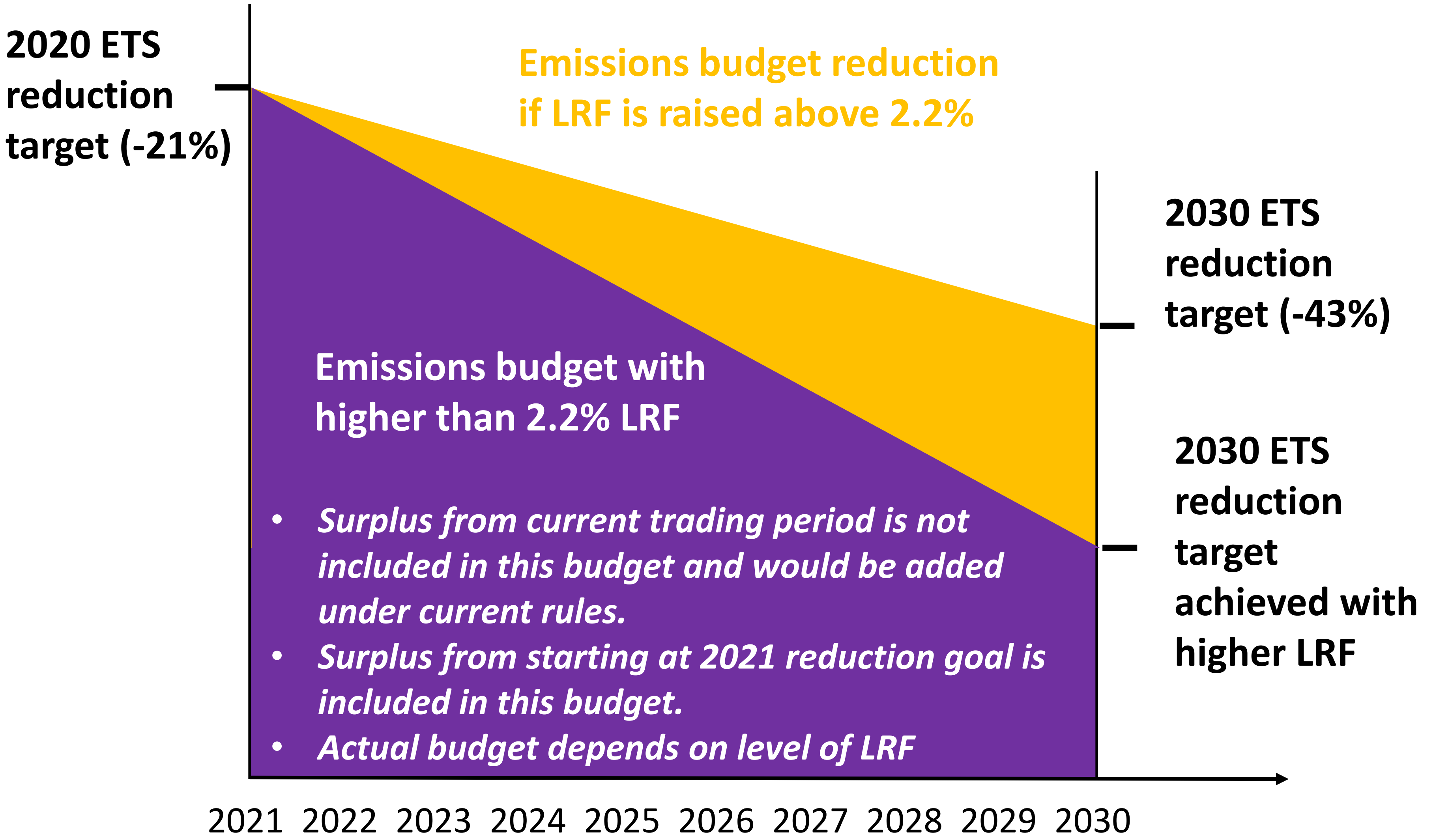
The proposed LRF of 2.2% would lead to ETS reductions by 2050 of only 84% compared to 2005.

Raising the linear reduction factor has a slower but longer term effect and is also an important option, especially in combination with the first two, to ensure the ETS is turned into a functioning mitigation instrument.

CAN EUROPE CALLS FOR

- **A Linear Reduction Factor which leads to a cost effective greenhouse gas reduction of at least 95% until 2050. The linear reduction factor (LRF) should be raised well above the 2.2% currently suggested. A sharper increase of the LRF will be crucial to the further credibility of the system as it sends a long-term signal for the decarbonisation of the economy.**

Illustrative graph to show effect of raising Linear Reduction Factor



Raising the Target Every 5 Years

The current ETS proposal is to have a ten-year trading period. This is longer than any ETS trading periods so far. Such a long trading period can lead to inflexibilities and make it difficult to improve the ETS during that period.

The Paris Agreement includes the requirement for all countries to come up with contributions to reduce emissions every five years.

CAN EUROPE CALLS FOR

- **Increasing ETS targets every five years.** ETS trading periods should also be five years. The ETS Directive should in any case include a revision clause that requires the European Commission to upwardly increase the ETS target every five years until the ETS is in line with **a linear pathway that will ensure the EU lives up to its commitments under the Paris agreement, including to pursue to keep temperature rise below 1.5°C.**

No use of International offsets, ETS linking only under certain conditions

CAN EUROPE CALLS FOR

- **International offsets not to be used for the ETS target.** International offsets means fewer reductions in the ETS. The quality of Clean Development Mechanism and Joint Implementation offsets have shown to be low. The use of low quality offsets leads to a rise in global emissions. In order to protect the integrity of European mitigation targets, international offsets should not be eligible for compliance.

- **Any linking would need to ensure that the EU's domestic target will still be met.** If the EU links to other ETSs, it could become a net buyer or net seller of units, depending on the ambition of the target and abatement costs in both schemes. If the EU would become a net buyer, it would no longer meet its domestic target. This could be addressed by e.g. only allowing one-way linking (only allowing transfers of EU allowances from the EU to abroad but not vice versa) or raising the ambition of the ETS target **and** putting a quantitative limit on the amount of units that can be imported in the EU to ensure that the domestic target is still met.

2. Ensuring rapid mitigation action

The higher the carbon price the more incentive companies have to implement low carbon strategies. If the carbon price rises sooner, companies will act sooner, even if there is no change in the overall ambition (e.g. if the 2030 targets remain the same). Earlier action can prevent lock-in of carbon intensive installations and technologies.

2.1 Unused Allowances should not be used for New Entrants

2.2 Supporting policies and measures at national level

2.3 Maximize Auctioning of Allowances

Unused Allowances should not be used for New Entrants

According the European Commission ETS reform proposal, 395 mio unused allowances from Phase 3 (2013-2020) would be available for the New Entrants (new or expanded industrial facilities that get such allowances for free) after 2020 (Phase 4). This will increase the supply of allowances available to the market and lower the EU carbon price, undermining the purpose of the Market Stability Reserve immediately after it becomes operational.

CAN Europe calls for

- **All unallocated allowances from Phase 3 to be cancelled permanently.** This will ensure that unused surplus pollution permits from the third trading phase don't undermine post-2020 emission reductions. A second best option would be to ensure all unallocated allowances are placed and kept in the MSR rather than being reassigned to the Phase 4 NER.

- **Phase 4 allowances should be held aside for New Entrants after 2020.** Instead of using unallocated Phase 3 allowances for the New Entrants Reserve, 400 million allowances should be set aside from the Phase 4 free allowances cap for this purpose.

Supporting policies and measures at national level

The ETS in its current form is an obstacle to more ambitious climate goals some Member States may want to take. Alternative national policies and measures can ensure that climate action is not postponed and lock-in into high emitting infrastructure is avoided, e.g. a high enough CO_2 floor price, an Emission Performance Standard (EPS).

CAN Europe calls for

- **Member States to introduce alternative policies such as a carbon price, a carbon tax, or an Emission Performance Standards to apply for installations covered by the ETS. This should be complemented by allowing for the cancellation of allowances by individual Member States to ensure additional national mitigation action** in progressive Member States does not simply make it easier (by lowering the carbon price) for Member States that are lagging behind.

- **Member States to support climate action and innovation beyond the dedicated modernization and innovation funds set aside in the ETS, using revenues from auctioned allowances or other forms of taxation for this purpose.**

Maximize Auctioning of Allowances

- If companies have to purchase all their allowances, emitting greenhouse gas becomes more expensive and cleaner production becomes more cost-effective.
- This is one of the reasons why CAN Europe is in favour of rapidly moving to 100% auctioning of allowances.
- An increase in ETS auction revenues will allow national treasuries to increase funding for climate action programmes at home and abroad.

3. Industry handouts & windfall profits have to stop

Auctioning is the most cost-efficient, simplest, fairest, and most transparent way to allocate allowances, fully reflecting the polluter-pays principle. Increasing the share of auctioning can support larger investments in the tools needed for further decarbonisation and climate resilience, in the EU and internationally.

- 3.1 Phase out free pollution permits, move to 100% auctioning
- 3.2 Avoiding windfall profits
- 3.3 Benchmarks
- 3.4 Limit the hand-out of free pollution permits to those really at risk
- 3.5 Indirect costs

Phase out free pollution permits, move to 100% auctioning

Between 2013 and 2020, in total 6.6 billion allowances will be given out for free to industry with a monetary value of € 50 billion.

ETS revision proposal: continue many of the existing rules and hand-out of around 6.3 billion free allowances

CAN EUROPE CALLS FOR

- **The phase out of handing out free pollution permits** to avoid subsidies for carbon pollution in the order of €160 billion in the 2021-2030 period.

- **The share of emission allowances to be auctioned by Member States should be at least 57% and increase over time to 100%**. The 2% of total allowances set-aside for the Modernisation Fund should come on top of the 57% auctioning share.

Avoiding windfall profits

Some energy-intensive corporations have used the ETS to increase their cash flow, using the theoretical risk of carbon leakage as an argument to receive pollution subsidies from governments.

CAN EUROPE CALLS FOR

- **Sectors on the carbon leakage list should not be eligible to receive free allowances for the share of carbon costs that are passed on to customers.** This helps to avoid windfall profits by ensuring that sectors are not compensated for the carbon costs that they can pass on to their customers. This means in practice that the formula to determine the amount of free allowances for a company is adjusted to: *historic production level * benchmark value * percentage free allocation * correction factor* **** (100% – cost-pass through rate)***

- **Companies that decrease their production should see an equivalent reduction in their allocation of free allowances, in order to avoid windfall profits from selling surplus allowances.** The decrease in allowances should take effect if the decrease in production is 10-15% or more in any given year. If there is an increase in production, the share of free allocations should not decrease the overall share of auctioned allowances. Government authorities should furthermore be allowed to reclaim unused free allowances per month from companies that have closed production.

Benchmarks

The amount of free allowances that an installation receives is determined by performance benchmarks. The current benchmark values are determined based on performance data of the 10% most efficient installations in the EU in each sector based on their production in the years 2007 and 2008.

CAN Europe calls for

- **Base the benchmark values on the 10% best performers globally (in terms of greenhouse gas emission performance) on the global market, similar to the Japanese top-runner approach in consumer products.** This ensures that European installations receive an incentive to keep up with their global competitors. Accurate performance benchmarks will reduce the need for a downward adjustment of the overall amount of free allocations through the application of the cross sectoral correction factor.

- **As a second best option, annually adjust the benchmarks by the same percentage as the reduction of the overall ETS cap (e.g. the linear reduction factor).** The adjustments to the product benchmarks should follow the overall reduction pathway of the ETS sectors to keep the incentive of decarbonisation in line with the overall cap. If on the basis of the submitted production data it is shown that sectors have annually reduced their emissions intensity by more than 0.5% above or below the linear reduction factor, then the benchmark values shall be annually adjusted by an additional -0.5% or +0.5% on top of the linear reduction factor.

Limit the hand-out of free pollution permits to those really at risk

- The Commission's proposes that if *trade intensity x emissions intensity* results in a value of above 0.2 kg CO_2 per EUR Gross Value Added, the sector should receive 100% of its benchmarked allowances for free.
- Sectors considered 'not at risk' but would still receive 30% for free.
- In total 94% of industry's emissions would be on the "carbon leakage list" and receive 100% of their allowances up to their benchmark for free.
- These untargeted rules make it necessary to apply the correction factor in the post-2020 period to reduce the amount of free allocation to each industrial installation accordingly.

Limit the hand-out of free pollution permits to those really at risk

CAN EUROPE CALLS FOR

- **A tiered approach which means a targeted multi-step approach reflecting actual risk of carbon leakage should be used to limit free allocation, including a pathway to move to 100% auctioning of emission allowances.** If a more targeted approach to carbon leakage is chosen, there is no need to apply a correction factor (which reduces the free allocation to all industrial sectors equally). This should lead to less emission allowances given away for free and these left-over free allowances should be cancelled, or auctioned for innovation support.
- **The trade intensity of an industrial sector that determines the exposure to “carbon leakage” should exclude the trade to third countries that have implemented emission reduction policies comparable to the ETS.**
- **Sectors that are not at risk should not receive any free allowances after 2020.** This includes all sectors that are below the factor 0.2 and hence should be subject to 100% auctioning.
- **Restrict the validity of the carbon leakage list that determines which industries are eligible for free allocation of allowances to maximum 5 years.**
- **Exclude the option that would allow the European Commission to add sectors on the carbon leakage list based on a subjective, “qualitative” assessment.** This ensures that the assessment of the exposure of sectors to the risk of carbon leakage is made in the most transparent, democratic and objective way possible.

No indirect cost compensation

Currently Member States "may" provide compensation for indirect carbon costs in line with State aid rules. This is changed to "should" in the recent ETS revision proposal, where it is also specified that Member States should use the revenues from auctioning in this regard.

CAN EUROPE CALLS FOR

- **State aid for indirect costs should not be allowed** in order to keep the incentive for electro- intensive industry to switch to electricity with lower carbon emissions and avoid a distortion of the EU internal market. Innovation support could instead be directed towards industrial sectors with relative high indirect costs to enable efficiency improvements or a switch to sustainable renewables.

4. Funding Climate Action

4.1 Innovation fund (formally NER 300)

4.2 Modernization fund

4.3 Article 10c

4.4 Auctioning revenues for EU and international climate action

4.5 Establish International Climate Action Fund

4.6 Establish a Just Transition Fund

Sections 4.1, 4.2, 4.3 and 4.6 have not been finalized yet and will be added at a later date

Auctioning revenues for EU and international climate action

The proposal recommends that Member States ("should") use 50% of auctioning revenues for a specified list of items (see Article 10).

CAN Europe calls for

All ETS auctioning revenues to be earmarked for supporting climate policies, inside the EU and internationally. The reporting obligations under the Monitoring Mechanism Regulation can serve as a good basis to make this earmarking mandatory for all. Reinvestments of auctioning revenues into renewable and energy saving technologies, as well as adaptation action can create a virtuous cycle, where application of the 'polluter pays' principle can support investments in the tools needed for further decarbonisation and climate resilience, in the EU and internationally.

Establish International Climate Action Fund

The Paris climate deal re-commits developed countries to deliver 100bn USD by 2020, and extends the goal until 2025, while pledging to significantly increase adaptation finance from current levels. So far, the EU has turned to aid budgets alone as a source of climate finance, particularly for adaptation, and the use of auctioning revenues to help diversify sources has been minimal and unpredictable.

CAN Europe calls for

- **Establishing an International Climate Action Fund.** The International Climate Action Fund would be modelled on the Innovation and Modernisation fund, so that earmarking is not necessary at a Member State Level. It would be replenished with a portion of ETS allowances, with revenues automatically and predictably channelled as climate finance, for example through UN climate funds like the Green Climate Fund. These funds would be supplemental to existing climate finance provision, coming on top of existing pledges. It would stop the diversion of ODA and be an independent, alternative source of revenues which would take the pressure off of national budgets, and stem the alarming slide of development aid towards climate finance.

5 . Ensuring ETS incentivizes only sustainable bioenergy use

The majority of renewable energy consumed in the EU is bioenergy. At least half of the biomass consumed for power and heat in the EU in 2012 was burned in ETS regulated installations. **This use of biomass is erroneously rated as having zero greenhouse gas emissions.** This is incorrect because it ignores the emissions from land and forests resulting from increased harvesting, depletion of carbon stocks, and emissions from direct or indirect land use change. In addition, solid and gaseous bioenergy does not need to comply with sustainability criteria of any kind.

CAN EUROPE CALLS FOR:

- **The ETS Directive must subject the use of biomass to comprehensive sustainability criteria and correct carbon accounting.** The ETS reform needs to ensure that it follows the new framework on biomass.
- **Reporting and transparency on the use of biomass under the ETS needs to be improved to allow for a better assessment of the kind of bioenergy used**. Reporting of CO_2 emissions from biomass both at an installation and Member State level must be mandatory and made public.
- **ETS funding for bioenergy use must follow strict sustainability criteria.** ETS support from the innovation and modernization funds and through article 10 c must be conditional to strong safeguards that ensure the long-term sustainability of bioenergy projects, see recommendations on funds in chapter 4.

6 . Addressing emissions from Aviation and Shipping

Emissions from aviation and shipping pose a great challenge for EU climate policy. The Council and the European Commission have called for actions that cover all sectors and sources of emissions, including international aviation and shipping. But currently only intra -European flights are included in the ETS. The emissions of international flights departing from or arriving in the EU have been temporarily excluded from the ETS and maritime emissions are not included at all in the EU's 2020 climate commitment.

CAN EUROPE CALLS FOR:

- **The ETS should cover 50% of all outgoing and 50% of all incoming international flights from 2017 onwards.**

- **All shipping emissions should be included within the 2030 ETS emissions reduction target in line with the 2013 Commission's Impact Assessment from 2021 onwards. In addition, a compensation fund should be established under the ETS Directive.** Shipping companies should not receive any free allowances and the auctioning revenues should be earmarked for the Green Climate Fund. Shipping companies would be allowed to opt out and contribute to a compensation fund before the decision on the number of allowances to be auctioned is taken.

→ For more recommendations, see our position paper

7 . Ensuring road transport reduces emission outside of the ETS

Article 24 of the ETS establishes the procedures for unilateral inclusion of additional activities and gases in the ETS. The Council Conclusions of October 2014 include a reminder of that option. As part of the 2030 climate discussions, German carmakers as well as the oil industry have advocated for the inclusion of road transport emissions in the ETS. However, the Commissions is not proposing such an inclusion and CAN Europe strictly opposes the inclusion of road transport in the ETS, either at the EU level or at the national level by individual Member States because it would:

CAN EUROPE CALLS FOR:

- **Amending article 24 to ensure that individual Member States are not allowed to incorporate the road transport sector in the ETS**.

- **Including a recital mentioning that incorporating the road transport sector within the activities in the ETS (Annex 1 of the Directive) would not be beneficial for reaching the EU's long term decarbonisation goals and that fiscal and economic measures and fuel efficiency standards for road transport should be strengthened and implemented.**

Final words

- **Absent reforms that go well beyond what the European Commission is proposing, companies can delay or cancel investments in cleaner and more efficient production.** This risks a lock-in of carbon intensive infrastructure for years to come, making Europe's climate goal more time-consuming and costly to achieve.
- **It is important that policy makers take into consideration research-based facts.** Disproportionate receptiveness to intensive lobbying of a small number of energy-intensive industry lobby groups could hold back effective reform.
- **The ETS can at best support achieving the necessary long-term decarbonisation.** A price signal is important. But a price signal alone, even if it was considerably higher, will not be sufficient to facilitate transformational change.
- **Even if the reforms were to be bold and swift we will need other strong policies, such as for renewable energy and energy efficiency, and binding bioenergy sustainability criteria** that accurately account for emissions from biomass.

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Europe

Thank you for your attention

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