EUROPEAN COMMISSION

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Detailed questions and answers on the proposal to revise the EU emissions trading system (EU ETS)

Key changes

1. What has the Commission proposed today for the revision of the EU ETS?

The European Commission has presented a legislative proposal to revise the EU emissions trading system in line with the 2030 climate and energy policy framework agreed by the EU leaders in October 2014. This is the first step in delivering on the EU's target to reduce greenhouse gas emissions by at least 40% domestically by 2030 as part of its contribution to the new global climate deal due to be adopted in Paris this December.

To achieve the 40% EU target, the sectors covered by the EU ETS will have to reduce their emissions by 43% compared to 2005. The key changes are:

- The overall number of emission allowances will decline at an annual rate of 2.2% from 2021 onwards, compared to 1.74% currently. This amounts to an additional emissions reduction in the sectors covered by the ETS of some 556 million tonnes over the decade – equivalent to the annual emissions of the UK.
- The proposal further develops predictable, robust and fair rules to address the risk of carbon leakage which may occur if production is transferred to countries with less ambitious climate policies. The system of free allocation is revised in order to distribute the available allowances in the most effective and efficient way to those sectors at highest risk of relocating their production outside the EU (around 50 sectors in total). An additional number of free allowances will be set aside for new and growing installations, and more flexible rules will allow to better align the amount of free allowances in cases of closures and production increases. It is expected that around 6.3 billion allowances will be allocated for free to companies over the period 2021-2030 – worth as much as EUR 160 billion.
- Several support mechanisms will be established to help the industry and the power sectors meet the innovation and investment challenges of the transition to a low-carbon economy. An Innovation Fund will be set up to extend existing support for the demonstration of innovative technologies to breakthrough innovation in industry. Free allowances will continue to be available to modernise the power sector in lower-income Member States. In addition, a dedicated Modernisation Fund will be established to facilitate investments in modernising the power sector and wider energy systems and boost energy efficiency in these Member States.

2. Why will the linear reduction factor increase to 2.2%?

The linear reduction factor determines the pace of emission reductions in the EU ETS. As the ETS sector is set to achieve a 43% emissions cut by 2030 compared to 2005, the linear reduction factor needs to be increased from 1.74 % to 2.2% from 2021 onwards. As a result, the number of allowances to be annually put in circulation as of 2021 (by auctioning or free allocation) will decline by about 48 million annually

3. Can European industry be compensated for higher electricity costs resulting from the ETS (indirect carbon costs)?

The ETS Directive already allows Member States to provide partial financial compensation to installations, which consume a lot of power in their production processes, for increases in electricity prices due to the EU ETS, so-called indirect carbon costs. The level of compensation is decided by each Member State, financed by national resources and provided via state aid schemes. As the compensation is implemented under a prescribed set of rules (*Guidelines on state aid measures in the context of the EU ETS*), this ensures that the differences across national/regional energy markets are taken into account, while leaving discretion to Member States to determine the most appropriate use of auction revenues.

Under the new proposal this basic approach would remain after 2021, with Member States being actively encouraged to provide partial compensation for indirect costs from their auction revenues.

4. How will small and medium sized enterprises (SMEs) be affected by the proposed EU ETS revision?

To reduce administrative costs for installations with low emissions – including SMEs and micro-enterprises – the Member States will get a new opportunity to exclude the small emitters from the EU ETS, as long as they are subject to equivalent national measures. This opt-out option is also possible under the current trading period (2013-2020). This comes on top of many measures already implemented to benefit SMEs, for example with regard to monitoring, reporting and verification of emissions from which SMEs benefit.

Free allocation and carbon leakage

5. Why will the benchmarks be revised?

The benchmarks' values will be updated twice during the period 2021-2030 to reflect advances in technology. The first update will be for the benchmark values used as of 2021 and these values will be kept stable until 2025. The second update will concern the benchmark values applied as of 2026 and these values will in turn be kept stable until 2030.

The allocation of free allowances is based on benchmarks that take into account the emissions performance of the most efficient installations. Thus, the system rewards highly efficient installations and incentivises less efficient installations to reduce emissions.

To retain these rewards and incentives, European leaders have given strategic guidance for the benchmark values to reflect the rate of technological progress. Current values are determined based on data from 2007-2008 and would therefore not be relevant to reflect the state of technology in the next decade.

6. What is the merit of using a flat-rate approach to revise the benchmarks?

The proposed flat-rate revisions provide a high level of predictability for industry. As all sectors should contribute to reducing emissions, benchmark values will become more stringent across the board.

Benchmark values would be reduced by 1% every year, as a default value. Based on experience on technological progress, this is at the lower end of what industry has been able to achieve in terms of reducing their emissions intensity over recent years. For all sectors the real rate of improvement will be verified based on real data. If this reality check indicates that for a sector technological progress deviates substantially from this flat rate, a lower or higher rate would be applied. The three improvement rates proposed are thus the following:

- The **central default flat rate of 1%** will apply to all sectors that have a verified improvement rate in the range of 0.5% and 1.5% annually. This provides predictability to the majority of sectors.

- The **low flat rate of 0.5%** will apply to all those sectors that have an annual improvement rate lower than 0.5%. This way also the slowest sectors contribute, but with due consideration of their specific situation.
- The **high flat rate of 1.5%** will apply to sectors with an improvement rate faster than 1.5%. This implies that the fastest moving sectors will have a more generous benchmark than the data shows, thereby letting those sectors keep some of the benefits of fast-improving carbon efficiency. E.g. a sector improving by 3 % annually will be able to keep half of the gains made.

7. How will the revised system of free allocation respond better to changes in production?

The Commission proposes that allocation decisions beyond 2020 are made for a period of 5 years. In phase 3 (2013-2020) the allocation decisions have been made for 8 years. This shorter period allows the use of more recent production data.

The system will also be more flexible in taking into account production decreases or increases during the trading period. In phase 3 installations could only receive more free allowances, if production increases were the result of adding capacity of an installation. Beyond 2020 free allowances would also be provided for increases of production without adding capacity. This is particularly beneficial for growing installations and sectors which have idle capacity as a result of the prolonged economic crisis.

8. Will a correction factor apply in phase 4 (2021 to 2030) with the proposed carbon leakage rules?

The agreement by EU leaders on the 2030 framework provides that the share of allowances to be auctioned should not decline. As a result of this the amount of free allocation is limited. In total roughly 6.3 billion allowances will be available for this purpose between 2021 and 2030. This necessitates that the ETS Directive contains a clause to avoid over-subscription of the free allocation budget also beyond 2020.

At the same time the proposed rules have been crafted so that the likelihood and magnitude of any correction factor becoming necessary beyond 2020 is significantly reduced. Among other features this is achieved by:

- Feeding the phase 4 new entrants reserve with some 400 million unallocated allowances from phase 3;
- Channelling allowances not allocated in phase 4 due to (partial) closures of installations into the new entrant reserve;
- Reducing the number of sectors featuring on the carbon leakage list in phase 4;
- Updating twice the benchmarks to reflect technological advances;

- Updating twice the production figures used to determine free allocation.

The future level of any correction factor will be driven by the technological innovations of industry to reduce emissions as well as the production growth compared to the current base years dating back to 2010 or earlier. If e.g. industries improve their technologies such that emissions reduce on average by more than 1% per year the need for the correction factor will already be significantly reduced. Beyond the rough figures presented in the accompanying impact assessment it is not possible to provide more precise estimates as detailed calculations will need to rely on the data on technological innovation and production volumes that will be collected once the ordinary legislative procedure will be finished.

9. What does the proposal mean for the most efficient installations?

Putting a price on carbon and allocating free allowances by means of a performance-based benchmarking approach makes the most efficient installations in a sector more competitive relative as they would always need to purchase a lower number of allowances. These installations should in turn also find it easiest to recuperate carbon costs in the market.

The proposed rules, in particular the continuation of the benchmarking system and the range of measures foreseen to minimise the need for any correction factor beyond 2020 respond to the strategic guidance by EU leaders, namely that the most efficient installations should not face *undue* carbon costs.

10. How many allowances will remain unallocated in phase 3 and what will happen to them?

Considering that phase 3 is in operation until 2020, at this point only estimates can be made about the amount of allowances that would not be used until the end of the decade. Market analysts expect some 550 to 700 million allowances to remain unallocated.

The rules of the recently agreed Market Stability Reserve (MSR) foresee a block transfer of unallocated allowances into the MSR in 2020 to ensure the orderly functioning of the European carbon market. At the same time the Commission was mandated to consider in the impact assessment accompanying the ETS revision proposal whether alternative use should be made of unallocated allowances.

On the basis of assessing the impacts the Commission concluded that some of the unallocated allowances should indeed be used for other purposes. It is therefore foreseen that 250 million allowances will be used for free allocation to new and growing companies (new entrants reserve), and an additional 50 million allowances would be used to support innovation in industry (Innovation Fund) in phase 4.

11. How many allowances will be available for new entrants and production increases?

The proposed structure of the new entrants reserve is similar to the current system in phase 3, but it will be more flexible to ensure sufficient amount of free allowances for new and growing companies. As a starting amount, around 400 million allowances will be reserved for this purpose, to be replenished from production reductions or plant closures throughout phase 4. This amount is similar to the amount that was set aside for this purpose for phase 3, which is estimated to be largely sufficient. While the new reserve will also be used for production increases it will be filled up by production reductions, so overall it is deemed to be more than sufficient.

Auctioning

12. What is covered by the 57 % auction share?

The European Council agreed that the share of allowances to be auctioned under the EU ETS post-2020 should not be reduced. This was an important and integral part of the agreement on the wider 2030 climate and energy framework. The auction share comprises allowances auctioned by Member States. This includes the regular auction volume, including the 10 % auction volume re-distributed for solidarity purposes, as well as allowances auctioned for the Modernisation Fund.

13. What are the benefits of fixing the auction share in the ETS Directive?

In phase 3 the auction share was only known with much delay after a number of technical implementing steps have been taken. Fixing the auction share in legislation has considerable positive impacts on transparency, predictability and the functioning of the carbon market. It will enhance planning certainty of investment decisions and transparency for market participants inside and outside the system, as well as for the wider public. It will render the EU ETS simpler and more transparent.

14. Are changes to the auctioning process proposed?

No. The rules for auctioning remain largely unaffected by the proposed revisions. The distribution key for sharing revenue from auctioned allowances between Member States remains the same. The auctioning infrastructure remains intact and concerned Member States keep the possibility to designate an opt-out auction platform instead of a participation in the common auction platform. The only difference concerns the number of eligible Member States benefiting from the 10 % redistribution of the auction volume for solidarity purposes. Beyond 2020 three Member States (Belgium, Luxembourg and Sweden) will no longer benefit from this provision.

15. How do the provisions for the use of auction revenue change?

The auction revenue will belong to Member States also beyond 2020 and the ETS Directive merely foresees that 50 % of the revenue *should* be used for climate and energy-related purposes. The Directive contains a list of such recommended purposes to which three new possibilities are added: (1) climate finance for vulnerable third countries, (2) indirect cost compensation and (3) promotion of skill formation and reallocation of labour affected by the transition of jobs in a decarbonising economy.

Low-carbon financing mechanisms

16. When will the allowances set aside to generate money for the Innovation Fund and Modernisation Fund be auctioned?

Some 710 million allowances will need to be auctioned for the two funds. This is a considerable amount of allowances. Hence the timing of auctioning these allowances is important. However, for operational purposes, the timing is not proposed to be set in the ETS Directive itself.

The allowances for the Modernisation Fund will be auctioned according to the same rules as other allowances. The operational rules for the auctioning of allowances for the Innovation Fund will be assessed and defined in future implementing legislation.

The Commission's impact assessment analysed several options for the timing and volume of monetising allowances for the Modernisation Fund and Innovation Fund. A balanced approach is needed to provide certainty of available funds, while avoiding a negative impact on the carbon market.

17. Are small scale projects eligible for funding under the Innovation Fund and Modernisation Fund?

Small scale projects will be eligible for funding under the two funds, as was the case for the NER 300 funding mechanism in 2013-2020.

For the Modernisation Fund, the Investment Board will develop specific guidelines and investment criteria for small scale projects.

For the Innovation Fund, the rules for small scale projects will be assessed in the context of the future implementing legislation.

18. Can the same project receive funding from different low carbon funding mechanisms or other EU instruments?

It is possible to combine funding from one of the low-carbon mechanisms with other EU instruments. The overall amount of public support granted will have to be taken into account for any future state aid rules, as is currently the case for the NER 300 programme. Further operational rules for the Innovation Fund will need to be set out in future implementing legislation.

19. Why can only 10 Member States benefit from the Modernisation Fund, while all Member States contribute allowances to setting up the fund?

The investment needs in lower income Member States to meet the 2030 climate and energy objectives are relatively higher compared to their GDP, while they also have high potential for cost-effective reductions in greenhouse gas emissions. This is due to a variety of factors, including their relatively carbon-intensive and ageing energy infrastructure and a large potential for efficiency improvements.

At the same time, they have more limited financial resources, which may limit the potential to finance these investments without public support. Providing financial support for realising the emission reductions in the lower income Member States through the Modernisation Fund can thus contribute to cost-effective reductions from a European perspective as well as to the priorities of a European Energy Union with a forward-looking climate policy: more sustainable, secure, competitive and affordable energy for both citizens and businesses. Recognising this, European leaders agreed in October 2014 that the beneficiary Member States to the Modernisation Fund would be those 10 lower income Member States with a GDP per capita below 60% of the EU average (in 2013).

20. Who will propose and select projects for the Modernisation Fund?

The beneficiary Member States will propose a pipeline of possible projects, from which projects to receive funding will be selected.

A balanced governance structure will be established with an investment board responsible for the rules and guidelines and a Management Committee responsible for the day-to-day management, including project selection.

The investment board and the Management Committee will include representatives from Member States, the European Investment Bank (EIB) and the Commission.

21. Can companies in all Member States seek support from the Innovation Fund?

Yes, as is the case for the existing NER 300 mechanism, which supports projects in 20 Member States all over EU, companies in all Member States can seek support from the Innovation Fund for demonstration projects in low carbon innovation for renewables, carbon capture and storage or industry. Further details on the operational rules for the Innovation Fund, including the eligible technologies will be assessed and regulated by future implementing legislation for the Innovation Fund.

22. Which technologies will be eligible for the Innovation Fund? How will projects be selected for the Innovation Fund?

In addition to support for renewables and carbon capture and storage, the Innovation Fund will be opened to first-of-a-kind demonstration projects for low-carbon innovation in industry. To ensure that the funds are used effectively, no breakdown between these three categories is defined. The proposal envisages a maximum funding rate of up to 60% (instead of 50% under current rules). Furthermore, it is proposed that 40% of total funding can be given if the project attains pre-determined milestones based on the technology deployed.

Further details on the operational rules, including eligible technologies and funding rates will be outlined in implementing legislation for the Innovation Fund.

23. Will there be specific rules for industrial innovation in industry?

The selection of projects for industrial innovation in industry will be linked to replicability. Replicability could for example be measured in terms of EU installations that could implement the same solution. Further details will be defined in the future implementing legislation for the Innovation Fund.

24. How much funding can a single project get from the Innovation Fund?

The maximum 15% limit ("funding cap") of the total funding from the Innovation Fund which can be given to an individual project will remain after 2021. However, as the budget of the Innovation Fund will be composed of a higher amount of allowances than the budget of the current NER 300 mechanism, the absolute limit will in practice be higher.

Further details on the operational rules, including the funding rates will be assessed and regulated by future implementing legislation for the Innovation Fund.

25. How will greater transparency be guaranteed for free allocation to the power sector after 2021?

Member States are required to select investment projects of more than EUR 10 million based on a national competitive bidding process with the aim to deliver the best value for money. The rules will set clear reporting requirements for the Member States and provide the Commission with the responsibility to publish important information on the investments carried out. However, the rules for the competitive bidding are to be set by the Member State and do not need to be notified to the Commission.

Projects below EUR 10 million can be also included; for those project the requirement for a competitive bidding does not apply. The Member State must select them based on clear and transparent criteria and the results of this selection process should be subject to public consultation. The Member State concerned must establish and submit a list of such investments to the Commission by 30 June 2019.

26. How many allowances can a Member State, eligible for such free allocation, provide to its power sector after 2021?

90% of the auctioned allowances are distributed after 2021 based on verified emissions, and the other 10% are to be redistributed among Member States with less than 90% of EU average GDP in 2013 for the purposes of solidarity. The 10 lower income Member States, with a per capita GDP of less than 60% of the EU average in 2013, may choose to provide up to 40% of the allowances from their national auction budget, without taking into account those allowances they receive due to redistribution, to their power sector for free in return for investments in modernising the energy sector.

Other changes

27. Does the proposal contain rules for the one-off reduction ETS allowances towards Member States' non-ETS targets?

No. The one-off flexibility between ETS and non-ETS foreseen in the European Council conclusions of October 2014 is not included in this proposal. Rather, this flexibility will be analysed in the course of developing the proposal to set national reduction targets for the non-ETS sectors in a fair and balanced manner.

28. Will the allowances from the current trading period be valid after 2020?

Yes. Allowances from the current trading period will be valid beyond 2020. The fourth trading period will run from 2021 to 2030.