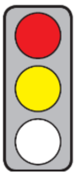
KEY ISSUES

Objective of the Directive: For those sectors that are subject to the EU Emissions Trading System (ETS), the rules on emissions will be tightened from 2021 to bring them into line with the 2030 Greenhouse Gas Reduction Target.

Affected parties: All companies subject to the ETS, other energy-intensive enterprises.



Pro: Adjusting the benchmark reduction by 0.5%, to bring it into line with the actual emissions, means that the incentives for emissions reduction correspond more closely to the actually achievable possibilities.

Contra: (1) The stricter measures increase the risk that companies will leave the EU due to increased costs (carbon leakage). This damages the economy without helping the climate. The provision of free emissions allowances should therefore be extended.

(2) As part of the reform of the ETS Directive, additional sectors – in particular road transport and heating – should have been included in the ETS.

(3) Authorising the Commission to determine, by way of a delegated act, which greenhouse gases are covered by the Directive, is in breach of EU law.

CONTENT

Title

Proposal COM(2015) 337 of 15 July 2015 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

Brief Summary

► **Context and objectives**

– The EU has undertaken to reduce its greenhouse gas emissions (GHG emissions) by at least 20% by 2020 as compared with 1990 levels (Art. 28; European Council, Conclusions of 8/9 March 2007, para. 32).

– In 2014, the European Council laid down stricter targets for the reduction of GHG emissions for the period 2021–2030 (Conclusions of 23/24 October 2014, para. 2; see cep**Input** No. 2/2015).

- The 2030 GHG reduction target amounts
  - in all sectors, to at least 40% as compared with 1990 levels,
  - in non-ETS sectors, to at least 30% as compared with 2005 levels and
  - in ETS sectors, to at least 43% as compared with 2005 levels.
- The ETS is the "most important instrument" for GHG reduction.

– This proposal to amend the ETS Directive (2003/87/EC) aims to bring the ETS into line with the 2030 GHG reduction target as from 2021.

► **Scope**

From 2021, the ETS will also cover (Art. 2 in conjunction with Annex I)

– carbon dioxide (CO_2) and other greenhouse gases (Art. 3 (c) in conjunction with Annex II);

– plants generating electricity and heat, metal production and processing plants, mineral processing plants, plants manufacturing pulp and paper, installations in the chemical industry and for the capture and underground storage of CO_2 (CCS) as well as aviation.

► **How the ETS works**

– Under the ETS, the EU-wide overall volume of permitted GHG emissions is limited ("Cap", Art. 9). Companies in certain industries are only permitted to emit GHGs when they have the corresponding emissions rights ("allowances") (Art. 12 (2a) and (3)). An allowance permits the emission of one tonne of CO_2 or another GHG with an equivalent global-warming effect (Art. 3 (a) and (j), Annex II).

– Companies must surrender the exact number of allowances which corresponds to the volume of their GHG emissions for the previous year (Art. 12 (2a) and (3)). The allowances

- are auctioned by the Member States (Art. 10 (1)) or allocated free of charge (Art. 10a - 10c),
- are tradeable and can be transferred to any Person in the EU (Art. 12 (1))
- if issued since 2013, are valid indefinitely (amended Art. 13).

– The EU-wide permitted volume of emissions ("Cap") is reduced annually by a "linear reduction factor" (amended Art. 9). From 2021, this – currently 1.74% – will amount to 2.2% in order to achieve the GHG reduction target by 2030.

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- **Auctioning of allowances**
  From 2021, the share of allowances to be auctioned must amount to 57% (amended Art. 10 (1)). 43% will be allocated free of charge.

- **Free allocation of allowances**
  – In principle, all companies apart from electricity producers receive a free allocation of allowances (Art. 10a (1) and (3)).
  – 400 million allowances – until now it has been 300 million – are made available for CCS demonstration installations and for innovative renewable energy technologies ("Innovation Fund"; amended Art. 10a (8)).

- **Carbon leakage**
  – Companies with (production) plants in energy-intensive industries which are at risk of carbon leakage will, in particular, receive free allowances (Art. 10b).
  Carbon leakage refers to the relocation of companies (or parts of companies) – primarily in the form of investment relocation – from the EU to third countries resulting in a corresponding relocation of emissions.
  – Until now, a sector has been deemed to be at risk of carbon leakage where the additional costs of ETS increase the production costs by at least 5% and exceed the intensity of trade by 10%, or just one of these two criteria is met but exceeds 30%.
  – In future, a sector is deemed to be at risk of carbon leakage if the product from multiplying its intensity of trade by its emission intensity is greater than "0.2" (amended Art. 10b (1)). As a result of this, only approx. 50 rather than the existing 170 sectors – corresponding to 97% of all sectors – will receive free allowances [SWD2015) 135, p. 27].
    - The intensity of trade is the ratio between the total value of exports to and imports from third countries, on the one hand, and the total market size for the European Economic Area, on the other.
    - The emission intensity corresponds to the emissions in kgCO_2 divided by their gross value added.
  – If the product from multiplying the intensity of trade by the emission intensity for a sector is "0.18", that sector only receives free allowances where an assessment is carried out (amended Art. 10b (2)).
  – For sectors which are not within the ETS but which are nevertheless at risk of carbon leakage due to the rise in the electricity price caused by the ETS, Member States may provide compensation for some of these costs ("electricity price compensation"; amended Art. 10a (6)).

- **Allocation of free allowances to installations**
  The quantity of free allowances which are allocated to the individual installations of a recipient sector corresponds to the product of multiplying installation-specific "historic production levels", a sector-specific "benchmark", a sector-specific "carbon-leakage factor" and a "cross-sectoral correction factor" [SWD(2015) 135, p. 31].
  – The "historic production level" of an installation is its average production level
    - between 2005-2008 for the ETS period 2013-2020 [Decision (2011/278/EU) Art. 9],
    - between 2013-2017 for the ETS period 2021-2025 [SWD(2015) 135, p. 35],
    - between 2018-2022 for the ETS period 2026-2030 [SWD(2015) 135, p. 35].
  – The "benchmark" will create incentives for the reduction of GHG emissions. It is determined according to the average emission volume of the 10% most efficient installations in a sector during 2007 and 2008 (amended Art. 10a (2)).
  From 2021, the benchmarks will be reduced (amended Art. 10a (2)). This will take place, according to non-binding plans of the Commission, in two stages – 2021 and 2026 [SWD(2015) 135, p. 33-53 and p. 141 et seq.]. The size of the two reductions is based on the actual emissions which must be submitted by the operators for the first time in 2018 and then every 5 years: Where the average annual emissions reduction of a sector (amended Art. 10a (2), Art. 11)
    - is under 0.5%, its benchmark will be reduced by 0.5% per year, i.e. in 2021 by 7.5% and in 2026 by 10%,
    - is between 0.5% and 1.5% , it will be reduced by 1% per year, i.e. in 2021 by 15% and 2026 by 20%
    - is over 1.5% , it will be reduced by 1.5% per year, i.e. in 2021 by 22.5% and 2026 by 30%.
  – The "carbon-leakage factor"
    - is "1" for all sectors with a risk of carbon leakage (Art. 10 in conjunction with Art. 10b (1))
    - was "0.8" for all sectors in 2013 and has been reduced annually since 2014 so that it will be "0.3" in 2020; the additional reduction to "0" by 2027 currently still required will be abolished (amended Art. 10a (11) and Art. 10b (3)).
  – The uniform "cross-sectoral correction factor" will be set so that the amount of free allowances corresponds to 43% of the overall amount of all allowances (Art. 10).

- **Support for countries with low per capita income**
  Member States, whose per capita income in 2013 was 60% below the EU average, may
  – allocate free allowances to electricity producers for the modernisation of their energy sector (amended Art. 10c),

– receive funds from a newly established "Modernisation Fund" to support investment in the modernisation of the energy system and to improve energy efficiency during the period 2021 to 2030 (new Art. 10d).

- **Amendments to the Directive by the Commission**
  – In particular, the Commission may, by way of delegated acts (amended Art. 23 in conjunction with Art. 290 TFEU),
    - change the list of GHGs (Annex II) covered by the ETS (amended Art. 22)
    - determine which sectors satisfy the legal definition of carbon leakage risk (amended Art. 10b (4)),
    - establish the Modernisation Fund (new Art. 10d (7)) and
    - change the regulations on the allocation of allowances for demonstration installations (amended Art. 10a (8)).
  – In particular, the Commission can implement by way of implementing acts (Art. 291 TFEU) the benchmark reductions for the period from 2021 (amended Art. 10a (2) in conjunction with new Art. 22a).

Statement on Subsidiarity by the Commission

The ETS is an existing EU instrument which will be continued after 2020. Since climate change is a cross-border problem, is can be dealt with better at EU level than at national level.

Policy Context

The European Council already agreed to a large number of changes to the ETS Directive in 2014, inter alia a fixed proportion of allowances for auction, which is no lower than the current proportion, and the new linear reduction factor. In December 2015, the UNFCCC Climate Protection Conference is due to take place in Paris. In a Communication about this conference [COM(2015) 81; see cep**PolicyBrief** No. 10/2015] the Commission announced the 2030 GHG Reduction Target – which will be served by this amendment to the ETS Directive (2003/87/EC) – as the EU's contribution to a global binding Climate Change Agreement.

Legislative Procedure

15 July 2015 Adoption by the Commission

Options for Influencing the Political Process

Directorates General:	DG Climate (leading)
Committees of the European Parliament:	Environment (leading), Rapporteur TBA
Federal Ministries:	Environment (leading)
Committees of the German Bundestag:	TBA
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of the Member States which make up 65% of the EU population).

Formalities

Legislative competence:	Art. 192 TFEU (Environment)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

With the ETS, the EU has opted for an effective instrument for reducing GHG emissions: It provides a reduction target for the economy as a whole and leaves it up to the market players to find out where reductions can be achieved at the lowest cost.

When amending the ETS Directive, the EU should take account of the results of the UNFCCC Climate Conference in December 2015 and make additional GHG reductions dependent on a concrete and credible international consensus in order to avoid economic damage to the EU. Since climate change is the result of the total amount of global GHG emissions, the climate can only be protected globally. The more countries that take part in climate protection the lower the risk of carbon leakage.

It is crucial for sectors at risk of carbon leakage to be able to receive free allowances from 2021 so as to prevent companies from relocating to third countries. **The new linear reduction factor of 2.2%, the fixing of the share of allowances to be auctioned** at 57% **and the reduction of the benchmarks, increase the risk of carbon leakage** however, because companies that are at risk now receive fewer free allowances than previously which increases their costs. **This** increases the risk of relocation and thus **damages EU economies without helping the climate. Companies at risk of relocating should therefore receive a larger proportion of free allowances** than planned **as from 2021.** Alternatively, the EU should allocate all

allowances free to all sectors; for the effectiveness and efficiency of the ETS, it is irrelevant whether allowances have to be purchased or are allocated free of charge since unused allowances can be sold for profit.
The fact that Member States can compensate for electricity price increases caused by the ETS in non-ETS sectors, does reduce the incentive to innovate brought about by these increases, but it prevents industry from relocating to countries with low electricity costs and should therefore be seen as positive. On the other hand, however, the proposal that Member States may explicitly only compensate part of the costs, increases the risk of carbon leakage.
The support for countries with a low per capita income, particularly the establishment of the Modernisation Fund, does increase the administrative burden, but it also increases the likelihood that the ETS will be supported by these countries and will remain in place as an EU-wide measure to combat climate change.

Impact on Efficiency and Individual Freedom of Choice

As part of the reform of the ETS Directive additional sectors – particularly road transport and heating of buildings, which together make up approx. 33% of GHG emissions in the EU **– will have to be included in the ETS.** This would significantly increase the efficiency of the ETS because the spectrum for finding more cost-effective avoidance potentials becomes greater as more emitters are subject to the ETS.
The new definition of carbon leakage risk allows the sectors which are actually at risk of carbon leakage to be more precisely determined. The sectors which will no longer benefit in future currently receive fewer than 5% of free allowances.
In some sectors, the blanket reduction of the benchmark fails in its objective of creating incentives for the reduction of GHG emissions. Instead it gives rise to costs in this area because some installations – e.g. those producing combined heat and power – have already exhausted the technological possibilities to the extent that a more efficient operation is not possible.
Adjusting the benchmark reduction by 0.5%, to bring it into line with the actual emissions of a sector, **means that the incentives for emissions reduction correspond more closely to the actually achievable possibilities.** The resulting smaller reduction also alleviates the increased risk of carbon leakage caused by the benchmark reduction.

Impact on Growth and Employment

Climate protection obligations require investment in emissions reduction. This has a negative impact on growth and employment as these investments are no longer available, to the same extent, for a more productive use. A fall in economic growth is the price to be paid for the avoidance of the unquantifiable damage caused by climate change which represents the benefit to be set against the decline in growth. The effective creation of incentives for GHG reduction will remain incompatible with the objective of securing growth and employment in key industries as long as there is no global treaty on climate change.

Impact on Europe as a Business Location

The new linear reduction factor and the resulting additional reduction in GHG volume as from 2021, will lead to unilateral cost increases for the EU without any appreciable benefit to climate policy. As long as there is no global treaty on climate change, unilateral reductions will damage Europe as a business location.

Legal Assessment

Legislative Competency

Unproblematic. The EU is empowered to issue environmental measures for the protection of the climate (Art. 192 TFEU).

Subsidiarity

Unproblematic.

Compatibility with EU Law in other Respects

The authorisation for the Commission to determine by way of delegated act (Art. 290 TFEU) **the greenhouse gases covered by the Directive** (Art. 3 (c) in conjunction with Annex II)**,** pertains to the scope of the Directive and thus to an essential element of the provisions. Since this provision does not therefore constitute a "non-essential element" (Art. 290 (1) TFEU) only affecting technical details, it must be established by the EU legislative – the European Parliament and the Council. The authorisation **is** therefore **in breach of EU law.**

Conclusion

The new linear reduction factor of 2.2%, the fixing of the share of allowances to be auctioned and the reduction of the benchmark, increase the risk of carbon leakage. This damages EU economies without helping the climate. Companies at risk of relocating should therefore receive a larger proportion of free allowances as from 2021. As part of the reform of the ETS Directive, additional sectors – in particular road transport and heating – should have been included in the ETS. Adjusting the benchmark reduction by 0.5%, to bring it into line with the actual emissions, means that the incentives for emissions reduction correspond more closely to the actually achievable possibilities. Authorising the Commission to determine, by way of a delegated act, which greenhouse gases are covered by the Directive, is in breach of EU law.

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