PISM POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 13 (863), 11 February 2016 © PISM

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The Domino Effect: Impact of the Global Climate Agreement on Post-2020 EU Emissions Trading Scheme Reform

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At the end of 2015 a landmark climate accord was adopted at the COP21 climate summit in Paris. The Paris Agreement may significantly impact the ongoing debate about the post-2020 reform of the EU's Emissions Trading Scheme, proposed by the European Commission in mid-2015. To reflect the Paris Agreement in the EU's domestic policies, some Member States may advocate strengthening the Commission's proposal. In such a scenario the Polish government should call for an increase of the Modernisation Fund and auction allowance redistribution rules, supporting energy transition in lower-income Member States.

The European Commission's proposal for the EU's Emissions Trading Scheme (EU ETS) post-2020 reform was presented in July 2015. It aims to improve the functioning of the EU's carbon market in order to reach the EU's target of reducing greenhouse gas emissions by at least 40% by 2030. The European Council agreed this goal in October 2014, but EU leaders also decided to revisit the issue after the COP21 climate summit. A number of stakeholders may demand a more ambitious target, as the Paris Agreement commits all parties to purse efforts to limit global warming to below 1.5°C while the EU's goal reflects an attempt to keep the increase below 2°C. A more ambitious goal may be supported by enough Member States to form a majority (meaning it would become the European Council's official position) and the European Parliament, which is involved in shaping the final compromise under the ordinary legislative procedure.

ETS Post-2020. The Commission's proposal for the ETS reform is in line with the guidelines defined by the European Council. It proposes delivery of the EU's 2030 emission reduction goal of at least 40% in the most cost-effective manner, which would involve a 43% reduction in the ETS (including the energy sector and manufacturing industries) and 30% in non-ETS (including other sectors, for example, transport, building and agriculture) by 2030 (compared to 2005). To reach the 43% ETS target, the Commission proposed an increase of the linear reduction factor (LRF), determining the pace of emission reductions. The proposal foresees an LFR increase from the current 1.74% to 2.2% from 2021 onwards.

According to the proposal, redistribution of the auction allowances among Member States would not vary significantly from the current formula. Redistribution of 90% of auction allowances would be according to Member States' verified emissions, while 10% would be redistributed among lower-income Member States (including Poland) for the purpose of solidarity.

The Commission proposed the establishment of two new funds, the Modernisation Fund and the Innovation Fund. The former would be set up with 2% of the total quantity of allowances for 2021 to 2030 (about 310 million allowances), in order to support ten lower-income Member States from Central, Eastern and Southern Europe in improving energy efficiency and modernising their energy systems. Poland would be the biggest beneficiary of this fund. The latter fund, capitalized with 450 million allowances, would support low-carbon innovation projects in industrial and renewable sectors, as well as CCS technology development.

An optional free allocation to the power producers in lower-income Member States (including Poland) would be maintained between 2021 and 2030. This free allocation should not exceed 40% of the particular Member State's auction allowances budget (without taking into account solidarity allowances). Making use of this provision would require (as now) corresponding investments in the modernisation and diversification of the energy sector. The Commission proposed that investments exceeding €10 million would have to be selected in a competitive bidding process (organised by Member States opting for the free allocation).

To address the potential risk of carbon leakage, the Commission proposed a continuation of the free allocation of allowances to industry sectors. At the same time, the list of sectors eligible for a 100% free allocation would be cut (from the current 150 to about 50) and better targeted to ensure those at the highest risk of relocating their production outside the EU are well protected (for example, the same allocation methodology currently applies to steel production and tomato puree production). Moreover, the proposal foresees a review of the free allocation every five years (in order to better align it with production data), and additional allocations for significant production increases. To reflect technological progress, benchmark values would be updated twice between 2012 and 2030. Sectors not considered to be exposed to the potential risk of carbon leakage could receive a 30% free allocation by 2030 (according to the current rules, this allocation would expire by 2027).

Towards a More Ambitious Climate Goal. Some Member States may demand that the Paris Agreement is reflected in the EU's 2030 climate goal, and in consequence in the rules governing ETS functioning post-2020. Although the UK was the most vocal supporter of a more ambitious EU mitigation target during negotiations on the 2030 climate and energy framework, a number of other Member States have added their voices since COP21. French President François Hollande has announced that he would aim for "a review of emission reduction commitment." The Swedish environment and energy ministers called for the EU to increase its mitigation commitment. Germany hasn't ruled out that the Paris outcome should be reflected in EU climate policies. Furthermore, the Netherlands has placed a "forward-looking policy on climate and energy" among the Dutch European Council presidency priorities, while Slovakia, which will hold the presidency in the second half of 2016, has in recent years supported all proposals to improve the functioning of the EU's carbon market (such as backloading and the Market Stability Reserve mechanism (MSR)).

As a legal basis for the ETS reform proposal in the EU's environmental law, the leading committee in the European Parliament (EP) responsible for developing the EP's position on this file will be ENVI (the Committee on the Environment, Public Health and Food Safety). Nevertheless, the Committee on Industry, Research and Energy (ITRE) would also be involved in forming the European Parliament's position on the Modernisation Fund, the Innovation Fund, the free allocation for the power sector, and measures to prevent carbon leakage. In all these sectors, the ITRE and ENVI will share competence. Such an arrangement aims to secure a compromise between the pro-environment ENVI and the pro-industry ITRE, and to help the EP agree on a position swiftly. The Scottish MEP to lead this process, rapporteur Ian Duncan (European Conservatives and Reformists), is of an opinion that the EU's 2030 climate goal and ETS ambition should both be revisited as they are incompatible with the 1.5°C target.

Recommendations. Rules governing the EU's carbon market after 2020 will have a major impact on the bloc's industrial competitiveness, on budgetary auctioning revenues, and on the level of support for low-carbon transformation in the lower-income Member States. What may be viewed as mere technical details could, during negotiations, prove decisive in decisions on the allocation of millions of euro. Although the reform proposal was presented by the EC six months ago, both the Council and the European Parliament are only now starting active development of their positions. It is no coincidence that this is happening only after the Paris Agreement.

For Poland, ETS reform is an opportunity to receive significant financial aid to decarbonise and modernise its energy sector. In order to seize this opportunity, the Polish government should remain actively involved in the debate about post-2020 ETS reform, even if calls for more ambitious EU climate goals become more vocal.

In such a case, the Polish government may take one of two courses of action. The first would be to object to a more ambitious ETS mitigation goal. However, the European Council will adopt its position in a qualified majority vote, so securing the support of other countries would be crucial (there will be no veto option in the vote). It is difficult to judge how likely it would be for Poland to build up a blocking minority coalition, although in recent years similar efforts have failed. The second solution would be for Poland to identify what elements of the Commission's proposal should be revisited in regard to a more ambitious ETS climate goal. The government could advocate increasing the Modernisation Fund or enlarging the pot of allowances for redistribution among lower-income Member States (the solidarity fund). Moreover, if the proposal to retire allowances is presented, the Polish government should aim to ensure that the allowances affected are exclusively those of higher-income Member States.