Department
of Energy &
Climate Change

The UK’s position on Phase IV of EU ETS

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Any enquiries regarding this publication should be sent to us at eu.ets@decc.gsi.gov.uk

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Executive summary

The UK supports the significant steps taken so far to improve the functioning of the EU ETS, such as the creation of the Market Stability Reserve (MSR). The proposed reform of the system for Phase IV comes at a critical juncture and offers a key opportunity to address outstanding structural issues which reduce the effectiveness and credibility of the scheme. In order to build a more effective EU ETS that provides the right incentives to achieve abatement at least cost, while supporting industry through the transition to a low-carbon economy, the UK supports:

- **An EU ETS cap in line with the EU's target of at least 40% domestic Greenhouse Gas emission reductions by 2030 from 1990 levels,** honouring the October 2014 European Council Conclusions.
- **A secure, liquid carbon market.** This is critical to provide the right incentives for installations to reduce their emissions, driving cost-effective abatement and innovation. To ensure this, a sufficient proportion of EU ETS allowances must be released to the market via auctioning.
- **Targeted, cost-effective and risk-based carbon leakage support.** In the context of a declining supply of free allocation, support should be focused on those sectors at greatest risk of carbon leakage, with low- and middle-risk sectors also receiving proportionate support. A strong evidence base is vital to achieve this.
- **The minimisation of administrative burdens on operators, especially small emitters.** It is vital that costs for all operators are kept as low as possible, in order to reduce the competitiveness impacts of the EU ETS, and that measures are taken to support small businesses.
- **Funds that support decarbonisation of the UK's and EU's industrial and energy sectors are administered cost-effectively**. The Innovation and Modernisation Funds must help drive the decarbonisation needed to enable the EU to meet its 2030 and 2050 targets by supporting industry in the transition to a greener economy. To achieve this, funds must be governed in a transparent and cost-effective manner.

The UK's Position on Phase IV of EU ETS

The EU ETS is Europe's flagship climate policy, and the world's largest cap-and-trade system. The EU ETS demonstrates Europe's ambition to act as a global leader in tackling climate change through a functional and effective carbon market whilst supporting the competitiveness of key industrial sectors. The continued success of the EU ETS is vital in helping the EU to meet its 2030 and 2050 targets at least cost and to lay the foundations for a global carbon market.

The EU ETS has already achieved many of its objectives with many companies significantly reducing their emissions. There is also evidence[1] that more companies are factoring carbon pricing into their investment decisions. However, the current Phase of the EU ETS has revealed structural issues in the EU ETS which weaken the effectiveness and credibility of the system. These include the persistent surplus and consequent weak low-carbon investment signal, as well as industry protection measures which do not adequately reflect actual risk of carbon leakage, complex administrative processes, and opaque procedures for securing access to funds.

The introduction of the MSR will help address the surplus of allowances and it is essential that the integrity of the MSR is maintained in the next phase of negotiations. However, there are still significant challenges ahead. The negotiations on Phase IV of the EU ETS come at a critical point; a strong outcome is vital to maintain and improve the status of the EU ETS as a secure, functional, and credible carbon market which supports competitiveness.

Phase IV Proposal

The Commission's proposal to reform the EU ETS is a welcome first step in creating a more robust and effective system. In particular the proposed split between auctioning and free allocation of allowances, the broadened scope of the new Innovation Fund and the rationalisation of the carbon leakage list are all positive steps to strengthen the EU ETS. However, there are outstanding issues with the proposal which must be addressed in order to create a more effective system.

A secure, liquid carbon market

The UK supports the proposed 57%/43% split between auctioned allowances and free allocation, in line with the October 2014 European Council Conclusions. It is important that adequate free allocation is supplied to those industries at risk of carbon leakage. At the same time, a sufficient supply of allowances must be made available on the open market for purchase by power generators and industrial installations.

Reducing the share of auctioned allowances could have a damaging impact on the carbon market, with the potential to reduce liquidity for power and non-carbon leakage sectors substantially. It would also place a greater onus on the power sector to decarbonise while reducing the incentive for industry to invest in abatement measures.

[1] World Bank Group (2015)

Targeted, cost-effective and risk-based carbon leakage support

The UK recognises the real risk of carbon leakage. There would be no benefit, in either environmental or economic terms, of installations leaving Europe for areas with less ambitious climate policies as a result of the costs of participating in EU ETS. The UK supports the continued use of free allocation to mitigate the risk of carbon leakage. Numerous studies have shown no robust evidence of carbon leakage from the EU ETS in the current Phase so far; this has been due in large part to free allocation as well as the lower than expected price of carbon[2]. However, as the carbon price rises and free allocation becomes scarcer, it is likely that highly exposed sectors could become subject to carbon leakage risk. It is therefore vital to the success of ETS that the industrial competitiveness of key energy intensive industries is supported.

In the current phase of the EU ETS, the vast majority of energy-intensive industry sectors - representing around 97% of industrial emissions - have been deemed at significant risk of carbon leakage; in order to mitigate this risk, sectors at risk are entitled to a substantial quantity of free allowances to reduce their carbon costs. The high number of sectors deemed at risk of carbon leakage under the current assessment criteria has led to the introduction of the Cross-Sectoral Correction Factor, which removes free allocation by a fixed percentage from all installations regardless of their risk in order to keep the total amount of free allocation below the maximum level. The result of this is a risk that those installations which are genuinely exposed to carbon leakage receive less support than they need.

The European Commission's legislative proposal has a carbon leakage list which is much shorter in terms of sector numbers (with around 50 sectors qualifying for carbon leakage status), but which covers only a slightly smaller share (94%) of industrial emissions. Under the current proposals, DECC analysis indicates that the reintroduction of the CSCF is therefore likely, meaning sectors at most risk would remain exposed.

The UK's preferred approach is for **a tiered approach to carbon leakage**. In a tiered approach, sectors would be classified as at (for example) high-, medium-, low- or no-risk, with allowances distributed accordingly. This would ensure that those sectors at greatest risk continue to receive as close to 100% of free allocation at their benchmarks as possible, while those sectors at lower levels of carbon leakage risk receive support more proportionate to their level of risk.

Benchmarks based on robust evidence

The UK is concerned by proposals for a flat percentage reduction in benchmark values for industry, which may not genuinely reflect technological improvements and could introduce competitive distortions between sectors. The UK believes that any changes to benchmark values should be grounded in a strong evidence base and accurately reflect the abatement potential of a sector, and differences in abatement potential between sectors. We will consider the Commission's proposal further in the coming months, and alternative options for improving benchmarking provisions.

Provisions for economic growth

The UK welcomes the Commission's proposed changes to allow installations to receive more free allocation when they have a significant increase in production, which will enable better alignment of free allocation with changing production levels, as called for in the October 2014 Council Conclusions. The UK would welcome further information from the Commission on how the new production-based system will work in practice.

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[2] See for example Vivid Economics (2014), Chatham House (2009) and Ecological Economics (2014)

Compensation for indirect carbon costs

The UK supports the continuation of the current state aid-based system allowing Member States to compensate electricity intensive industries for the indirect carbon costs of the EU ETS passed through to them by electricity providers. Under the current system there is an appropriate level of flexibility for Member States to decide whether they wish to compensate eligible sectors, subject to State Aid guidance. The State Aid guidance determines maximum levels of compensation that can be paid for the costs incurred by eligible sectors, reducing the risk of intra-EU distortions while maintaining necessary incentives to achieve abatement.

Minimising administrative burdens for operators, particularly for small emitters

The UK strongly supports measures to reduce the administrative burden of complying with the EU ETS, particularly for smaller operators. We welcome the proposed continuation of the ability for Member States to opt-out small emitters from the EU ETS and are exploring the implications of increasing the threshold. Beyond the small emitter opt-out, the Commission's proposal contains little detail on how the administrative burden of the system will be addressed. Simplification of the EU ETS should be a fundamental principle which the Commission, Member States and the European Parliament consider across the course of negotiations and in subsequent legislation.

Funds that support decarbonisation and are administered cost effectively

The UK welcomes the establishment of an Innovation Fund supplied with allowances from the free allocation portion of the EU ETS cap, as a successor to the NER300. The UK particularly welcomes the continuation of support for CCS projects and the inclusion of support for innovation in industrial technology and processes.

The UK firmly supports having a flexible Innovation Fund which supports innovation for both industry and the power sector and welcomes the Commission's proposal for a fund to act as a 'bridge' between the NER300 and the start of the Innovation Fund, to provide important support to 'early start' projects. The Commission's proposals to allow projects to access funding following achievement of defined milestones in their development provides greater flexibility, better reflects the reality of project development and should encourage a diversity of projects. While funding small-scale projects is important, larger scale, deep-decarbonisation measures must also play a key role. In order to ensure these funds enable this, it is important that their governance is open and transparent.

The UK supports the creation of a Modernisation Fund to support the decarbonisation of power production in lower income Member States as well as the continuation of the provision of free allocation to power producers in some Member States under article 10c of the Directive. The use of these funds should be transparent and operate in accordance with the environmental objectives of the EU ETS.

Please contact the DECC EU ETS team (eu.ets@decc.gsi.gov.uk) if you have any comments on Phase IV of EU ETS or the UK's position.

Department of Energy & Climate Change
3 Whitehall Place
London SW1A 2AW
www.gov.uk/decc
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