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Division and use of revenues in Phase 4 of the EU ETS – options to operationalise the December 2020 EUCO conclusions

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Objectives of this paper

This paper intends to capture the state of debate regarding the use of revenues from EU ETS allowances, as well as how revenues are to be divided among Member States. Special attention is given to the recent European Council conclusions from December 10/11, 2020.

The paper puts forward three options to operationalise relevant elements in the Council conclusions:

1. Increase the size of the Modernisation Fund;
2. Introduction of a new, separate pool of allowances; or
3. Change in the allocation key used to divide auctioned allowances between EU Member States.

This paper further outlines three main questions that should be considered by stakeholders and policymakers when deciding on the division and use of revenues in the EU ETS:

1. What share of the Member State's investment needs should be covered through (re)distributing auctioned allowances?
2. Which elements or principles should be taken into account in the allocation key to (re)distribute auctioned allowances between Member States?
3. Should the current spending rules for revenues from auctioned allowances or ETS funds be revisited?

While this paper focuses on EU ETS revenues, it should not be seen separate from the wider debate on climate ambition and the financing of the European Green Deal, as outlined in the European Green Deal Investment Plan, including through the Multiannual Financial Framework.

Introduction

Auctioned allowances from the EU Emissions Trading System (ETS), are divided among Member States according to their share of verified emissions in the baseline period (in 2005 or the average of 2005-2007, whichever is highest). In principle, these auctioning revenues can be used at a Member State's own discretion, although the EU ETS Directive specifies that at least 50% *should* be used for climate- and energy-related purposes. The Directive also stipulates that up to 25% can be used by Member States to compensate installations for indirect costs incurred through increased electricity prices due to the EU ETS.

Provisions have been introduced in the past to (re)distribute allowances to poorer Member States compared, or to set aside revenues to finance certain investments:

- **The Solidarity Provision**, introduced in phase 3, redistributes 10% of all auctioned allowances towards 16 lower-income Member States;
- **The Innovation Fund**, in operation since 2020, monetizes at least 450 million allowances over the coming decade to finance investments in low-carbon technological solutions; and
- **The Modernisation Fund**, introduced in Phase 4, redistributes 2% of the total quantity of allowances available over phase 4 towards 10 lower-income Central and Eastern European Member States, which are to be used to modernize their energy systems and improve energy efficiency.

As part of the upcoming revision of the EU ETS to make it 'fit for 55', one of the elements that EU institutions and stakeholders are looking at is how to make best use of, and how to divide revenues among Member States, as well as to what extent they should be earmarked for specific purposes.

Arguably, this issue has recently become more political and put high on the policy agenda for a number of reasons:

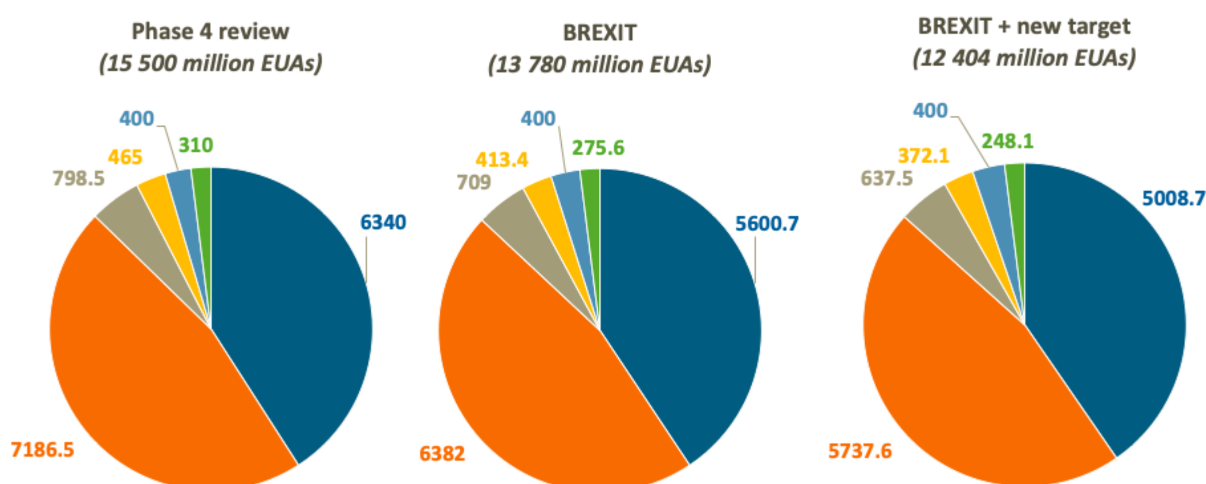
1. **Firstly**, in order to deliver on the increased 2030 climate target, substantive amounts of money will have to be invested in green solutions and technologies, and auctioning revenues can play a significant role. Member states, industry covered by the EU ETS and stakeholders in general seek assurances that auctioning revenues will be spent in line with the objectives of the European Green Deal. At the same time, an increased target raises concerns about carbon leakage among industrial stakeholders, who are looking towards the EU and Member States for sufficient protection.
2. **Secondly**, because of the strong rally in the price of carbon in recent years, auctioning revenues represent an increasingly significant sum of money. Moreover, revenues are anticipated to increase further in the near future, as the decrease in allowances to be auctioned (e.g. due to Brexit and a higher 2030 target) is widely expected to be offset by relatively faster rising EUA prices (see table 1 and figure 1 below). Moreover, revenues could further increase when, eventually, free allocation is substituted by auctioning and/or the ETS scope is extended to sectors currently not covered.
3. **Thirdly**, and somewhat incompatible with the first point, COVID-19 and the accompanying economic crisis have put pressure on Member State's budgets, and the auctioning revenues are seen by some as an interesting revenue stream to 'balance the books'. At EU level, the three institutions have been discussing the possibility to use part of the ETS revenues as an 'own resource' for the European Union, e.g. to finance debt repayments from the legacy of the Next Generation EU recovery plan.

Table 1: forecasted average CO_2 price over Phase 4 of the EU ETS - average of selected analysts.

	April 2019 *(before European elections)*	October 2019 *(before European Green Deal)*	October 2020	January 2021
Phase 4 average CO_2 price	€ 30.45	€ 36.85	€ 44.5	€ 53.85

Source: CarbonPulse
Note: average of selected analysts' forecasts

Figure 1: amount of available allowances during Phase 4 of the EU ETS



Source: ERCST
note: 'new target' is a target of -64.85% in 2030 as mentioned in the Commission's Impact Assessment accompanying the 2030 climate target plan

State of Play

In its communication on the European Green Deal[1], the European Commission first touched upon the use of EU ETS revenues, proposing to allocate 20% of the revenue from the auctioning of allowances to the EU budget as well as to *strengthen* the Modernisation and Innovation funds.

Both in the Inception Impact Assessment[2] and in the Public Consultation[3] for the EU ETS, the Commission's focus seems to be on the use of revenues, as is evident from some of the

[1] https://ec.europa.eu/info/publications/communication-european-green-deal_en
[2] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12660-Updating-the-EU-Emissions-Trading-System
[3] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12660-Updating-the-EU-Emissions-Trading-System/public-consultation

questions (e.g. *'are stricter rules necessary to ensure Member States spend ETS auction revenues in line with climate objectives?'; 'What should be the size of the Innovation Fund / Modernisation Fund?';' or 'should indirect cost compensation be further harmonized in Europe?'*)

While during 2020 Member States such as the Czech Republic and Hungary suggested an increase in size of the Modernisation Fund, discussions in the European Council have recently shifted more towards the *division* of auctioning allowances between Member States. Both avenues essentially address the same issue: how to get more financial resources to Member States that need them most to deliver the EGD.

At the Environmental Council of October 23, 2020, the Polish government presented several options to address what they perceive to currently be an 'unfair and unbalanced distribution of allowances'. Most notably, two options were presented which would change the current allowance allocation key for auctioned allowances:

1. Changing the reference period to a more recent period (e.g. 2016-2018), resulting in a division of allowances more in line with Member States' *current* share of verified emissions; and/or
2. Not include emissions covered by free allocation in the baseline (which they see as double counting those emissions).

Discussions continued further at Ministerial and European Council level, and at the December 10-11 European Council meeting, during which Member States endorsed a net domestic GHG reduction target of at least 55% by 2030.

While the European Council is expected to revisit and adopt additional guidance before June, three paragraphs in the Council conclusions are worth unpacking:

1) **Paragraph 14:** The new 2030 target needs to be achieved in a way that […] takes account of Member States' different starting points and specific national circumstances and emission reduction potential […] as well as efforts made;
2) **Paragraph 17**: The European Council invites the Commission to assess how all economic sectors can best contribute to the 2030 target and to make the necessary proposals […]. The Commission is invited to consider, taking into account the principles set out in paragraph 14, in particular […]
    i. […] taking into account the need to address distributional concerns and energy poverty
    ii. addressing concerns raised in relation to the distribution of efforts, fairness and cost- effectiveness […];

3) **Paragraph 18**: The problem of imbalances for beneficiaries of the Modernisation Fund in not receiving revenues that are equivalent to the costs paid by the ETS installations in those Member States will be addressed as part of the upcoming legislation.

While paragraphs 14 and 17 outline some general principles that should be respected in the entire energy and climate framework, including the EU ETS, paragraph 18 relates specifically to the EU ETS and the division of revenues, with language not dissimilar to the Polish non-paper from October.

As an external observer, paragraph 18 could be interpreted in different ways:

- Currently, installations in Member States which are beneficiaries of the Modernisation Fund need to purchase more allowances than their share of the auctioned allowances, or simply put: [Auctioned allowances < allowances purchased *(verified emissions – free allocation)*]
  It is worth noting that, based on data from the European Environmental Agency (EEA), this situation occurs in only 3 out of 10 Modernisation Fund beneficiaries (for 2017 and 2018 data)[4]
- Additional investment needs required by installations to reduce their emissions and deliver on the higher reduction targets should be taken into consideration as well. Undeniably, auctioning revenues will not be sufficient to cover both compliance costs and investment needs.

If the latter interpretation is correct, there are really two core questions that need to be considered:

1) How high are the additional investment needs in these Member States?
2) What share of these investment needs should be covered by redistributing auction revenues?

While the European Commission's impact assessment accompanying the 2030 Climate Target Plan[5] estimates additional energy system investment needs to rise by €65 – €102 billion per year compared to achieving the current 2030 climate and energy framework, there currently is no comprehensive assessment at individual Member State level, making a well-informed debate on the issues outlined above difficult.

[4] Which are the most straightforward years to assess, given the functioning of the Market Stability Reserve in 2019 and 2020, and the backloading of allowances in 2014-2016 limited the amount of allowances auctioned.
[5]

Options to operationalise the European Council's conclusions

Independent of the questions outlined above, three main options can be identified if the redistribution of allowances to be auctioned between Member States is the way forward:

1. **Increase the size of the Modernisation Fund**
    - Increasing the size of the Modernisation Fund seems to be considered by many stakeholders as the most evident way to operationalise paragraph 18 of the conclusions: the fund's beneficiaries are literally mentioned in the text, additional funds would flow towards energy system and energy efficiency investments, and there already are already clear investment and EU-level governance rules in place.
2. **Introduction of a new, separate pool of allowances**
    - A share of the total amount of allowances to be auctioned could be set aside and redistributed to certain lower-income Member States. Currently, 10% of allowances to be auctioned are already redistributed to 16 lower-income Member States "for the purpose of solidarity, growth and interconnections within the Union". Likewise, a pool of allowances could be set aside for certain Member States (e.g. the 10 Modernisation Fund beneficiaries). Contrary to the Modernisation Fund, Member States would be able to use revenues as they see fit, unless additional spending rules are introduced as part of a political compromise.
3. **Change the allocation key to divide auctioned allowances**
    - As a third option, the currently used allocation key to divide auctioned allowances between Member States can be updated in a manner that ensures that more revenues are available to those Member States with lower capabilities to pay for the investments needs associated with the EGD.

When considering these options, three key questions should be reflected upon by stakeholders and policymakers:

1. What share of the beneficiaries' investment needs should be covered through redistributing auctioned allowances?

A first key question revolves around the amount which should be redistributed to lower-income Member States. We already touched upon this issue earlier in this paper: if the objective of this redistribution excercise is indeed to help certain Member States bear the compliance costs and help finance their investment needs, it seems prudent to first decide what share should be covered by EU ETS revenues.

For example, in the Commission's phase 4 review' impact assessment[6], it was estimated that the Modernisation Fund would cover between 3% - 9% of the additional investment needs due to the 2030 climate and energy framework in the eligible Member States. A similar debate is warranted for the upcoming revision, yet is difficult as long as there is no Impact Assessment at Member State level.

2. Which elements or principles should be taken into account in the allocation key to (re)distribute auctioned allowances?

For any of the three options outlined above, an allocation key would either need to be developed or the existing one adapted in order to redistribute allowances.

For example, the Modernisation Fund is currently divided based on the 10 beneficiaries' 2013 GDP (50%) and share of verified emissions (50%). *If* the size of the Modernisation Fund is increased, the suitability of this current allocation key needs to be assessed: do other elements, such as Member State's actual investment needs, need to be taken into account?

Similarly, if a separate pool of allowances is introduced or the overall allocation key for dividing auctioning revenues is adapted, a discussion needs to take place on which elements will be included or introduced to that allocation key.

Two options to adapt the allocation key were introduced in the non-paper by the Polish Government:

1. Changing the reference period to a more recent period (e.g. 2016-2018); and/or
2. To not include emissions covered by free allocation in the baseline (Poland sees this as double counting for those emissions).

As the current allocation key is advantageous for those Member States who have a relatively large share of industrial emissions but a relatively low-carbon power sector, not including emissions covered by free allocation would indeed to some extent correct the 'imbalance' between costs paid and revenues received in some Member States. However, it should be noted that introducing such a change would severely limit these Member States' ability to compensate for the indirect costs borne by the energy-intensive installations.

Moreover, while changing the reference period to a more recent period would similarly better align the distribution of allowances to be auctioned with Member States' currently verified emissions, it would fail to recognise the efforts that were already made by Member States in

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reducing their emissions, and would be seen by some as a perverse incentive to not reduce emissions.

Beyond these two examples, other elements could be introduced to the allocation key. New elements that could be considered include:

- The *efforts made* so far by Member States in reducing their emissions *[e.g. emission reductions achieved since 2005]*
- Member States *relative capabilities [e.g. GDP/capita levels]*
- Member State's *actual investment needs [as calculated in the upcoming impact assessment]* .

Inevitably, introducing new elements to the allocation key will alter the current distribution of allowances to be auctioned, resulting in a relative increase/decrease in Member States' auctioned allowances, as is shown in Table 2 below.

While the size of this increase/decrease will ultimately depend on the weight that is given to each new element introduced, which is ultimately a political decision, it is important to first debate and agree on which elements should be included in the first place.

Table 2: possible elements to include in the auctioning allocation key, and impact on Member State's share of allowances to be auctioned

	Update reference year to a more recent year (e.g. 2018)	Discount Free Allocation in the allocation key	Premium for efforts made	Premium for Member States with relatively lower capabilities
Austria				
Belgium				
Bulgaria				
Croatia				
Cyprus				
Czechia				
Denmark				
Estonia				
Finland				
France				
Germany				
Greece				
Hungary				
Ireland				
Italy				
Latvia				
Lithuania				
Luxembourg				
Malta				
Netherlands				

Poland				
Portugal				
Romania				
Slovakia				
Slovenia				
Spain				
Sweden				

Source: ERCST based on EEA and Eurostat data

Interpretation: Member State will increase/decrease its share of allowances to auction compared to the current situation if this element is introduced in the allocation key.

3. Should the current spending rules for auctioned allowances or ETS funds be revisited?

A final issue that need to be discussed is whether or not the current spending rules need to be revisited and if so, how?

One of the questions included in the Commission's public consultation reads: *'Should the types of investments that can be financed by the Modernisation Fund be streamlined and the coherence with the Green Deal be enhanced?'.*

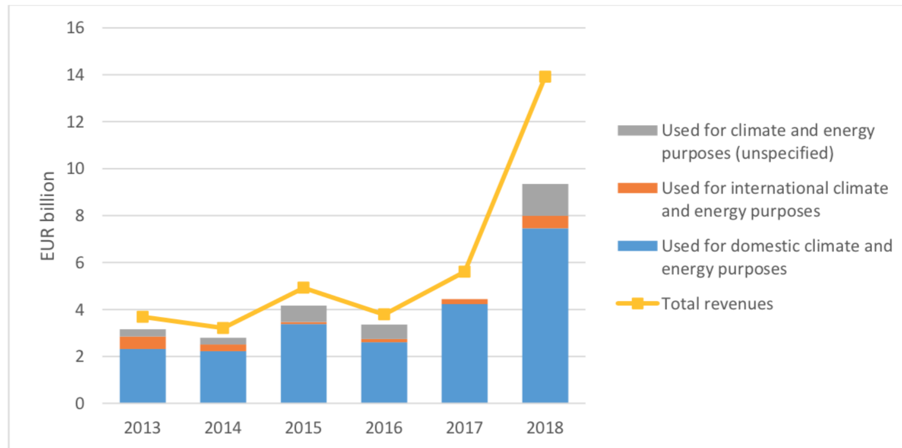
Under the current rules for the Modernisation Fund, investments in power plants using gaseous fossil fuels are still eligible, as well as investments in district heating using solid fossil fuels in Romania and Bulgaria. While some stakeholders are arguing to adapt these rules in the upcoming review and ensure that no fossil fuels can be eligible for investments, the legacy, both in terms of energy systems and matrix, that these countries have inherited needs to be factored in.

Similarly, some stakeholders have been calling for stricter spending rules for auctioning revenues in general to e.g. ensure they are in line with the European Green Deal and/or the 'do no harm principle'. Under the current rules, revenues can in principle be used at a Member State's own discretion, although at least 50% *should* be used for climate- and energy-related purposes (as listed in the EU ETS directive).

Member States on average report spending over 80% of ETS revenues for climate and energy purposes since 2013. However, this percentage has been decreasing in recent years as overall revenues have been rising. The large differences between Member States should also be noted.[7]

[7] WWF (2019). Strategic Spending: how the EU emissions trading system can fund fair climate https://d2ouvy59p0dg6k.cloudfront.net/downloads/strategic_spending___how_the_eu_emissions_trading_system_can_fund_fair_climate_action.pdf

Figure 2: Reported use of auctioning revenues by Member States, 2013-2018



<u>Source</u>: European Commission, 2019 (based on self-reporting by Member States)