



# RECOMMENDATIONS OF FUNDING MECHANISMS IN THE REVISED EU ETS

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**ERCST**

European Roundtable on  
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The EU Emissions Trading System (EU ETS) is one important source of revenues that should be used to support low-carbon investments and alleviate social impacts associated with the transition, in order to help put the EU on a trajectory towards net-neutrality by 2050.

At current market price projections, the

ETS could generate as much as €363 billion in auctioning revenues between 2021-2030, which should be fully mobilised to speed up the transition and leave no one behind.

In order to do so, ERCST and CEEP put forward the following recommendations in light of the review of the EU ETS under the European Green Deal.

## RECOMMENDATIONS

- 1. ENSURE AUCTIONING REVENUES ARE FULLY MOBILISED TO FOR CLIMATE AND ENERGY PURPOSES**
- 2. SAFEGUARD THE SOLIDARITY MECHANISM FROM THE FUNCTIONING OF THE MARKET STABILITY RESERVE (MSR)**
- 3. ENSURE AN ADEQUATELY INCREASED MODERNISATION FUND**
- 4. MAINTAIN TRUST AND STABILITY BY KEEPING FINANCING RULES FOR THE MODERNISATION FUND UNCHANGED UNTIL THE 2024 REVIEW**
- 5. TAKING ADDITIONAL FACTORS INTO ACCOUNT WHEN DISTRIBUTING THE MODERNISATION FUND AMONG MS**
- 6. ENSURE SUFFICIENT REVENUES ARE MOBILISED THROUGH THE INNOVATION FUND TO FINANCE BREAKTHROUGH LOW-CARBON TECHNOLOGIES**
- 7. EXPLORE ADDITIONAL FINANCING OPTIONS TO DEPLOY LOW-CARBON TECHNOLOGIES AT SCALE**

## CONTEXT

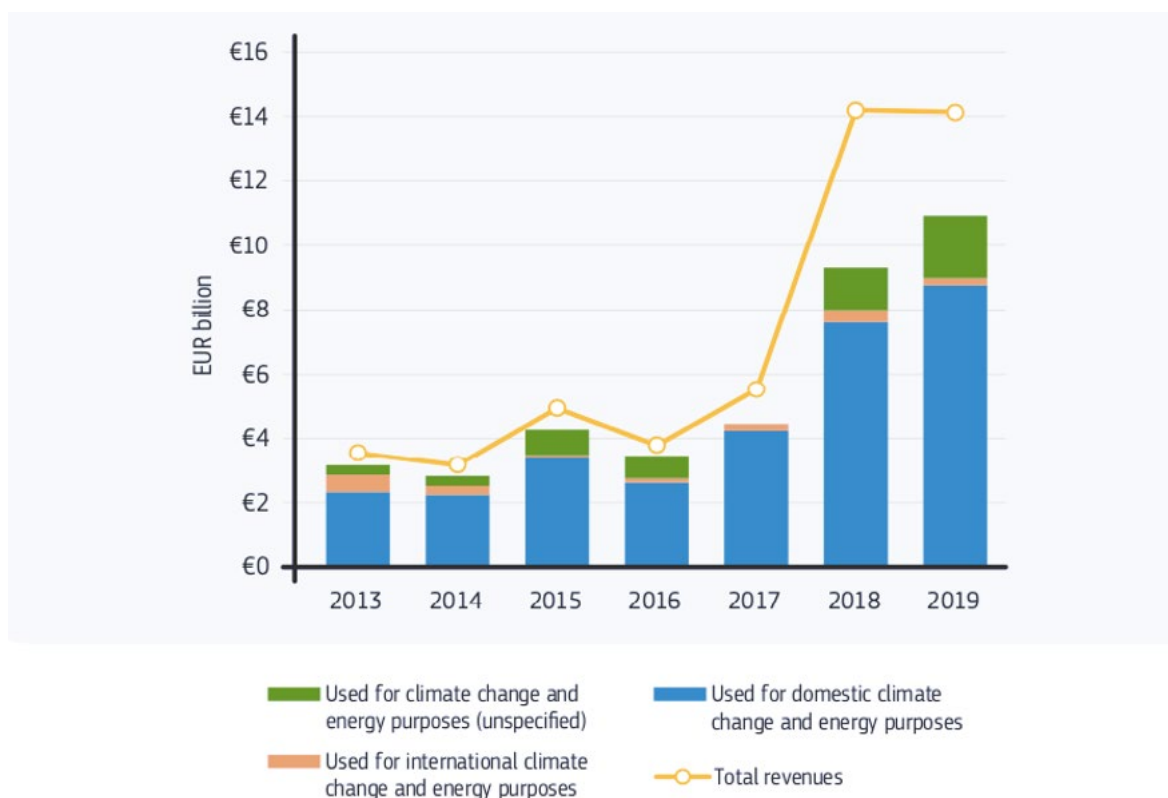
In the light of the ambitious, green and fair transition towards carbon neutrality by 2050, adequate financial support for low-carbon investments, as well as social purposes, needs to be made available to those sectors and Member States that need it the most, and those parts of the EU's society that will be hit the hardest during the transition. The transition will have to be just in order for it to be deemed successful.

The EU Emissions Trading System (ETS) is one potential source of revenues to support these objectives and has done so in the past. Auctioned allowances from the EU ETS are divided among Member States ac-

cording to their share of verified emissions and, 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.

Since 2013, the EU ETS has generated close to €70 billion in revenues, out of which close to 80% was, self-reportedly, spent by Member States on climate and energy objectives, though it is worth noting that large differences exist between Member States.

Figure 1: Total auctioning revenues and use of auctioning revenues<sup>1</sup>



Source: European Commission, 2021

<sup>1</sup> In 2020 auction revenues increased from €14.6 billion in 2019 to €19.16 billion in 2020. This increase is mainly attributable to the UK, which auctioned its combined 2019 and 2020 volumes last year. [See ERCST State of the EU-ETS Report 2021](#)

Moreover, provisions have been introduced in the past to (re)distribute allowances to poorer Member States, or to set aside revenues to finance certain purposes:

- **The Solidarity Provision**, introduced in phase 3, redistributes 10% of all auctioned allowances towards 16 lower-income Member States with GDP per capita below 90% of the EU average.

- **Article 10c Derogation**, introduced initially in Phase 3 and completely revised in Phase 4, Art. 10c Derogation allows eligible Member States with GDP per capita below 60% of the EU average, to finance investments for the modernisation of their energy sectors, by providing up to 40% of the proceeds from auctioning of their own national allowances to ETS installations. (Only 3 Member States decided to use this mechanism in Phase 4).

- **The Innovation Fund**, in operation since 2020, will monetise at least 450 million al-

lowances over the coming decade to finance investments in low-carbon technological solutions. It is the successor of **NER300**, a funding programme which made available about €2 billion for innovative CCS and renewable energy technologies.

- **The Modernisation Fund**, introduced in Phase 4, redistributes 2% of the total quantity of allowances available over phase 4, currently 280 million allowances, towards 10 lower-income Central and Eastern European Member States with GDP per capita below 60% of the EU average, which are to be used to modernize their energy systems and to 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 future revenues under the EU ETS, including to what extent they should be earmarked for specific purposes.

## How much money are we talking about?

Through the auctioning of allowances, the EU ETS has the potential to generate considerable amounts of revenues, which is ultimately determined by the product of the European Emission Allowance (EUA) price and the amount of allowances that will be auctioned.

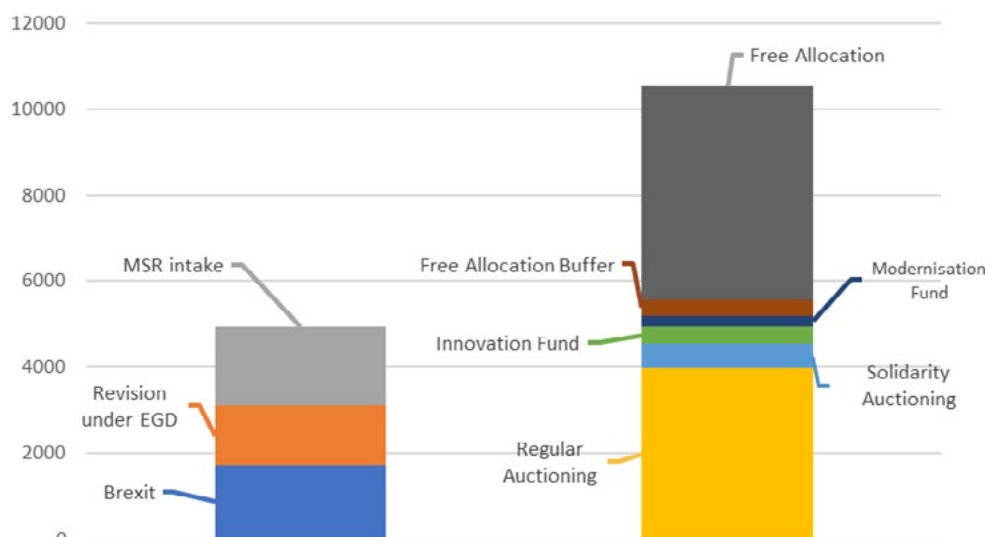
Following the review of the EU ETS in 2018, the total supply of allowances was estimated to be 15.5 billion over the course of 2021-

2030. However, this amount is/will be impacted by a number of elements, including:

- The UK leaving the EU ETS following Brexit <sup>2</sup>;
- The revision of the EU ETS under the European Green Deal (EGD); and
- The functioning of the MSR.

<sup>2</sup> The UK left the system at the end of 2020 and will establish a domestic emission trading system. The UK-based firms can still buy EU permits and have until end April 2021 to comply with the EU ETS for 2020.

Figure 2: Estimated availability of allowances in Phase 4 of the EU ETS (Y-axis)



Source: Own calculations

We estimate that these three elements will reduce the supply of allowances by 32% over Phase 4. After discounting for free allocation and the free allocation buffer<sup>3</sup>, about 5.19 billion allowances are estimated to be monetised in the coming decade. At average market prices in 2020

of 24Euro/t this would amount to €125 billion. With recent forecasts estimating the average price reaching between €50 and €70 in Phase 4, revenues would further increase to €296 - €363 billion.

## Why the ETS Funding mechanisms need to be adapted ?

ERCST and CEEP strongly believe that all ETS revenues should be utilised to speed up the transition and help alleviate the distributional impacts associated with its functioning, in order to ensure a sustainable transition as well as to increase support for the policy instrument. This can be done through increasing the resources for dedicated funds in conjunction with

ensuring that Member States spend their revenues in line with these objectives. Moreover, it is important to recognise both the different capabilities as well as different starting points in terms of Member States' energy systems and ensure that sufficient support is available for those Member States where the transition will be especially challenging

<sup>3</sup> Free Allocation Buffer: The amount of auctioned emission allowances in phase 4 is set at 57% of the total amount, but 3% of the total amount can be used as a free allocation buffer to avoid the use of a cross-sectoral correction factor.



E.g. transitioning away from the use of coal in Central and Eastern Europe will be especially difficult, and the associated economic and social impacts can be substantive if they are not addressed effectively and early on.

Sufficient support should be provided to avoid a ‘two-speed energy transition’ in the EU. The Modernisation Fund will be a vital instrument to ensure this in the coming decade and should be strengthened and meaningfully increased.

The same holds true for the various sectors covered by the EU ETS. While support will still be required for the power sector to continue to decarbonise, especially in Member States, the significant number of resources and support that has already flown to this sector has put it on a clear pathway towards full decarbonisation.

The decarbonisation of the EU’s industrial sector is still more challenging and uncertain due to a lack of commercial availability of decarbonisation technologies. The EU ETS should play a significant role in the coming decade in financing pilots for low-carbon technologies in the industrial sector, as well as support their deployment at scale. Therefore, The Innovation Fund should be used to support the development of these technologies.

Lastly, the EU ETS should contribute to ensuring that no one is left behind. In order to tackle these challenges, investing in human capital should play a key role during transition. Dedicating revenues for reskilling and upskilling of the labour force, as well as addressing distributional impacts and energy poverty concerns should not be overlooked and be threaded with equal importance to that of the technological challenge.

Indeed, investments in human capital are crucial and may even speed up of the development of clean energy technologies and help transforming businesses and communities to a low-carbon, sustainable future. Both the Modernisation Fund and general auctioning revenues should be mobilised to help mitigate the risk of job losses and other socio-economic impacts associated with the transition.

Based on ERCST and CEEP’s long-standing expertise on the EU ETS, previous work done on the funding mechanisms, engagement and consultations with climate policy experts, policymakers and stakeholders<sup>4</sup>, we propose 7 major recommendations to the use of auctioning revenues and design of the funding mechanisms.

<sup>4</sup> Through stakeholder meetings, workshops, surveys, interviews, etc.

## 1. Ensure auctioning revenues are fully mobilised to for climate and energy purposes

Since 2013, close to 80% of auctioning revenues has been spent on climate and energy purposes. However, this share has dropped in recent years as revenues increased considerably due to the rising carbon price.

In order to ensure that Member States continue to use these revenues to speed up the transition and mitigate any negative impacts, we support amending Article 10(3) of the [ETS Directive](#) to increase the share of auctioning revenues that should be spent on climate and energy purposes from the current “at least 50%” to 100%.

Moreover, in order to ensure that distributional impacts associated with the tran-

sition are addressed and no one gets left behind, we support adopting an amendment introducing a minimum threshold of 20% of auctioning revenues that should be spent by Member States to address social aspects in lower- and middle-income households (e.g. combat energy poverty) as well as finance other just transition purposes. Lastly, the list of areas captured in Article 10(3) should be amended to recognise certain other types of eligible expenditures, including infrastructure investments e.g. for connecting RES to the grid, energy storage facilities (including P2G infrastructure), hydrogen enabling technologies, biomethane facilities or CCS infrastructure.

## 2. Safeguard the solidarity mechanism from the functioning of the MSR

The solidarity mechanism redistributed 10% of the total quantity of allowances to be auctioned from the common EU27 pot to 16 poorer Member States. We believe this 10% to be a fair amount and believe this quantity should remain unchanged.

However, we believe the solidarity allowances should be safeguarded from the functioning of the MSR. Under current rules, this is only the case until 2025: until then, only the regular auctioned allowances are taken into account when determining Member States' share of allowances injected into the MSR, while from 2026 onwards the solidarity allowances are taken into account as well.

We estimate that this would decrease the total amount of solidarity allowances by as much as 10%. We strongly believe that the MSR should only take into account Member States' regular auctioned allowances as accounting for the solidarity allowances would disproportionately affect poorer Member States after 2025. As such, Article 1(5) of the MSR Decision ([2015/1814](#)) should be amended to completely safeguard the solidarity mechanism.

Of course, the same spending rules as for the other regular auctioned allowances should apply for the solidarity allowances, meaning that 100% of revenues should be spent on climate and energy purposes.



### 3. Ensure an adequately increased Modernisation Fund

While the Modernisation Fund on its own will never be sufficient to ensure the modernisation of the power sector in the 10 eligible Member States, ERCST and CEEP believe that the size of the Modernisation Fund should be increased to help facilitate and speed up the modernisation process and show solidarity with those Member States where the transition is especially challenging due to higher emission reduction targets.

The Modernisation Fund was introduced to help finance energy investments in 10 Central and European eligible Member States, and was initially estimated to cover between 3-9% of the additional investment needs associated with the 2030 climate and energy framework<sup>5</sup>, estimated by the Commission in 2014 at € 8.4 billion per year to implement 40% reduction target. Today, the Commission estimates 300 bn Euros per year of additional investments in the EU28 to meet 55% target. The sheer scale of the challenge is therefore much different.

We believe that a similar calculation at Member State level as in 2014 and discussion is warranted to determine an appropriate size of the Modernisation Fund, rather than making ungrounded statements on what percentage<sup>6</sup> of the total quantity of allowances should constitute the Modernisation Fund.

In order to do this, an impact assessment is necessary to estimate the additional investment needs associated with the European Green Deal in these Member States. Based on such impact an informed decision can be made as to what percentage of these investments are to be covered through the Modernisation Fund.

Given the likely scale of necessary investments, and increase in absolute terms, we believe that a proportional increase of climate effort should go hand in hand with a proportional increase of the Modernisation Fund.

### 4. Maintain trust and stability by keeping financing rules for the Modernisation Fund unchanged until the 2024 review

Two types of investments are eligible under the Modernisation Fund: at least 70% is to be spent on priority investments as captured in Article 10d(2), while less strict spending rules apply to the remaining 30% (though these require confirmation from the investment committee). Recently, some stakeholders have argued in favour of revising the spending rules for the Modernisation Fund, to ensure that no investments are made that are not in line with the objectives of the European Green Deal.

Based on the work ERCST and CEEP have undertaken previously on the Modernisation Fund as well as continuously interacting with policymakers and stakeholders, we believe that the large majority of the Modernisation Fund will be used to finance the so-called 'priority projects' and that the 'risk' of projects which are not aligned with the European Green Deal receiving financing is relatively low being already a subject of additional control mechanisms.

<sup>5</sup> <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52014SC0015>

<sup>6</sup> Currently the Modernisation Fund is financed through monetising 2% of the total quantity of allowances over Phase 4 of the EU ETS

As such, we do not see the need to revise the investment rules at this stage, especially since a revision is already scheduled to take place by the end of 2024. Moreover, Member States and project developers have been preparing for the start of the Modernisation Fund for the last 2 years through market analyses and stakeholder consultations. Announcing a revision of the eligibility criteria in the first few years that the Modernisation Fund operates could significantly

harm the trust of project developers as well as slow down crucial investment decisions due to the uncertainty that this would bring.

At the same time, gas investments are still considered to be a transitional technology which could be vital to ensure a sustainable transition and ensure security of supply as well as improve air quality in some of the Member States that benefit from the Modernisation Fund, and therefore should remain eligible.

## **5. Taking additional factors into account when distributing the modernisation fund among MS**

Currently, the Modernisation Fund is split among eligible Member States according to their share of GDP in 2013 (50%) and share of verified emissions (50%). ERCST and CEEP believe that this allocation key is not fit for purpose and should be adapted, at least for the additional allowances that will go to the Modernisation Fund.

As outlined above, the implicit objective of the Modernisation Fund is to help finance the additional energy system investment needs associated with the climate ambition. As such, we believe that the Modernisation Fund should not only be divided based on MS verified emissions and share of GDP but also based on their actual investment needs as well as on their relative capabilities.

An increased Modernisation Fund can help

Member States struggling most with the transition. The scale of the investments requires both the public sector to ensure the most efficient use of public resources and private sector to redirect and mobilize its financial flows. However, access to finance remains an obstacle to investment in a number of catching-up EU countries. In particular, in Member States with high private sector debt and leverage, access to bank credit is relatively more difficult and expensive than in the rest of the EU, holding back private investment.

Secondly, we believe that the relative capabilities of Member States should be factored in, meaning that Member States with lower GDP/capita levels should receive relatively higher share from the Modernisation Fund than Member States with higher GDP/capita.

## **6. Ensure sufficient revenues are mobilised through the Innovation Fund to finance breakthrough low-carbon technologies**

The first calls for proposals for the Innovation Fund have shown that both the interest from project developers as well as need for support are high: -311 applications were submitted for the

first call for large-scale projects, requesting in total €21.7 billion in support; and -232 applications were submitted for the first call for small-scale projects, requesting more than €1 billion in support.

However, for these two calls only €1.1 billion is available. Moreover, at current market prices, the Innovation Fund is ‘only’ expected to provide around €18 billion in financing over Phase 4, which is already insufficient to cover the requested amounts of the first call for proposals.

Given the large and likely growing interest from project developers, we believe that

the Innovation Fund should at least be doubled in size, financed directly through revenues generated by the introduction of a Carbon Border Adjustment Mechanisms (CBAM). Moreover, a geographical balance within Innovation Fund should be ensured to enable all countries to benefit from it.

## **7. Explore additional financing options to deploy low-carbon technologies at scale through the Innovation Fund**

Industrial decarbonisation is one of the major challenges of the current decade. Due to long investment cycles and aged infrastructure that will need reinvestments in the coming decade, the Innovation Fund should help ensure that these investments are in line with the carbon neutrality objective.

While according to European Commission’s impact assessment, industry can achieve the necessary reductions by 2030 through further adopting more energy efficient processes and through fuel switching, these actions will not put industry on track towards carbon neutrality by 2050.

In order to prepare industry for 2050 and ensure the uptake of breakthrough low-carbon technologies after 2030, the economic and technical feasibility of these technologies has to be proven at scale in the coming years. While the EUA price will play an important factor, it will not reach the levels necessary to do this in the coming decade.

As such, we believe that additional types of financing should be examined. Carbon Contracts for Difference (CCfDs) are one approach that should be explored, as

they could be used to deploy at scale certain ultra-low-carbon production processes currently still in the pilot/testing phase.

CCfDs offer an assurance about the future trajectory of carbon prices in the form of a fixed price for certain emissions reductions. Current prices are too low to make carbon-neutral technologies for many Emissions-Intensive and Trade-Exposed (EITE) industries economically viable, a CCfD will serve to guarantee the substantially higher carbon price needed to enable investments in technologies producing low- and ultra-low carbon materials.

The Innovation Fund should be revised to not only invest ‘first of a kind’ pilot projects, but also allow for financial report to scale-up and deploy these technologies through innovative financing mechanisms.

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