CARBON MARKET FORUM

CEPS

Thinking ahead for Europe

European Commission Public Consultation on revision of the EU Emission Trading System (EU ETS) Directive

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Chapter 1

Q1.1 The European Council called for a periodic revision of benchmarks in line with technological progress. How could this be best achieved in your view and, in particular, which data could be used to this end? How frequently should benchmarks be updated, keeping in mind administrative feasibility?

In answering the questions for this EC Consultation, one element that is critical and will colour the answer to most questions are the October Council conclusions. Council Conclusions are in this case fairly specific, and if they are to be taken beyond giving strategic guidance, they start to significantly narrow the options for the 2030 package, and the EU ETS structural reform in particular. This statement applies to the whole CEPS submission.

The guidance provided by the European Council Conclusions should be interpreted in a holistic manner. In talking about the future method of free allocation, the Conclusions mention that future allocations will be aligned more with changing production levels. Additionally, the benchmarks should follow technological development *in their respective sectors*. This informs how the role and functions of the benchmarks ought to be seen, including on the logic that should be used in making judgements about when they should be updated.

Benchmarks set the level of compensation for the most efficient installations in the sector, and ensure that installations that are performing well do not face "undue costs". Its purpose is to mitigate the risk of carbon leakage.

However, the benchmarks have another role, to ensure that there is a continued incentive for installations to improve efficiency, innovate and reduce emissions in order to reach the benchmark and receive 100% free allocation. Article 10a of the ETS Directive states "*ex-ante benchmarks [shall] ensure that allocation takes place in a manner that provides incentives for reductions…"* This could be seen, in some way, as an aspirational role. It is however important to ensure that the benchmarks are realistic and represent the situation in the sector.

With the Council Conclusions indicating that future free allocations should be more closely aligned with changing production levels, the role of the benchmark of providing that continued incentive to innovate becomes more important. In the current system, increasing output beyond historical levels of activity which determines the amount of free allocation and ensures a continuous incentive over time. With more frequent production updates, that incentive largely disappears.

What then should drive the updates to the benchmarks? This decision should take into account the technology and investment cycle in a given sector. This also means that for different sectors, the updates could take place at different intervals. There should also be a means to account for significant technological developments, to ensure that the benchmark is not outdated for extended periods of time.

There are some other considerations to be made:

Frequent updates to the benchmark would have an impact on certainty for operators. However, certainty can be expressed or alleviated through transparency and predictability on *what* would drive the updates in a given sector, leading to a good understanding of when to expect a benchmark update.

The sectoral approach to updating the benchmark also means that changes within a trading period should be considered as possible, and certainly not rejected out of hand. There is a case that is being made, and a valid one, for updating production levels in line with reality, within a trading period. If that is the case, the only defendable position, within the limitations of practicality and costs, is that the parameters should reflect reality. While it may seem elegant to link trading phases to benchmark updates, there is no good case to be made for linking trading periods to technology and replacement cycles in a given sector. In-period updates should well be possible.

In the current system, the CSCF increases the exposure to carbon costs over time (which may affect the incentives to innovate), and thereby erodes the degree of carbon leakage risk mitigation. Should it be decided to remove the CSCF correction, the role of the benchmark of providing an incentive takes on a new importance.

Benchmarks should also be set at a compensatory level for the most efficient installations in a sector, to isolate them from carbon costs. The 10% level currently used seems suitable for that. While for some, the Council Conclusion's language of "no undue carbon costs" may indicate that the benchmark should be aspiring for a sector, there is a risk to not rewarding the most efficient operators, in that it runs contrary to mitigating carbon leakage risk.

More frequent updates to benchmarks may result in higher administrative costs. This should be taken into account when setting the update intervals across sectors. At the same time, the information requirements of keeping aligned allocation with changes in production levels may result in more relevant data anyway.

Q1.2 The European Council has defined guiding principles for the development of post-2020 free allocation rules which provide inter alia that "both direct and indirect costs will be taken into account, in line with the EU state aid rules" and that "the most efficient installations in these sectors should not face undue carbon costs leading to carbon leakage" while "incentives for industry to innovate will be fully preserved and administrative complexity will not be increased" and while "ensuring affordable energy prices". Do you have views how these principles should be reflected in the future free allocation rules?

CEPS interprets the guidance from the European Council in a unitary way, that is, in the context of the whole document, which results in something akin to a decision-making tree. At the same time, it must be reaffirmed that the European Council's role is to "define the general political directions and priorities" and not "[to] exercise legislative functions" (Art. 15(1) TEU). A plain English interpretation is whether Council conclusions represent detailed instructions that we cannot deviate from, or general strategic direction, to be considered, but if necessary, adapted.

Taken as a whole, the Conclusions seem to signal a more evolutionary, rather than revolutionary approach to any structural changes to the ETS, as well as to the role of free allocation. The key statement seems to be that free allocation has the "objective of providing appropriate levels of support for sectors at risk of losing international competitiveness".

As in the current system, both direct and indirect carbon costs will need to be taken into account and provided for. The Council Conclusions seem to indicate that indirect emissions should continue to be addressed through state aid. However, this approach has created a significant amount of

dissatisfaction among those industrial actors who feel that it leads to distortions in the single market.

An alternative solution would be to address indirect carbon costs at the EU level, possibly through granting free allowances. This would beg the question, however, of where state aid would come in, as outlined in the Council Conclusions.

Another alternative would be address indirect costs from auction funds, harmonized at the EU level, with the electricity regulator having the responsibility to compensate electricity users. This is not dissimilar from the current California model.

There are some important implications for maintaining the state aid approach to indirect carbon cost compensation. As indirect carbon costs are operating costs, any state aid compensating such costs must be tapered over time. This reduces the degree of protection awarded by the system. Furthermore, as mentioned, the uneven playing field for indirect carbon costs remains in place, as state aid invariably involves a degree of Member State discretion.

This discussion seems to point in the direction of harmonization of compensation at the EU level, and a move away from State Aid, which cannot ensure a level playing field.

This uneven playing field can result, not only of production and investment impacts, but also in some perverse effects on the choice for technology of an installation. Given the inherent uncertainty of state aid (which is granted ex-post and at the discretion of each Member State), an operator may choose for a technology and production process, which is covered by (more predictable and ex-ante) direct carbon costs compensation. Practically this would translate into non electro intensive technologies. This, however, runs contrary to the aim of the ETS Directive, and the principle of technology neutrality.

While not mentioned in this question, but very much related to this set, the Council Conclusions also refer to updated production levels. This should increase the importance of benchmarks in maintaining incentives to innovate in low-carbon technology. Additionally, the phrasing “not face undue carbon costs” seems a fairly high test which should be translated into close to full compensation for the most efficient installation in a sector.

To complete the “logical tree in the context of potentially rising levels of production, a number of options can be proposed:

- The amount of free allocation is increased (at the expense of auctioning) and everyone gets what is ”needed”;
- The amount is kept the same, and fewer installations take a slice of it, or some take a smaller slice;
- With a downward slope of the cap, and the direction from Council Conclusions, of not reducing the share of allowances to be auctioned, the implication is that free allocation gets smaller over time.

The last two options, combined with the desire to keep energy prices low, point to a more focussed way of determining free allocation.

There are different ways in which free allocation to address direct emissions could be made more focussed. There can be differentiation according to the risk of carbon leakage in a sector. This would result in a more gradual system than the current system where a sector is either considered to be at risk, or not at risk at all. This approach is currently used in California, and while it is in its infancy, it has attracted attention and may be considered as a potential approach in the EU as well.

In addition, it may be that the criteria for determining carbon leakage risk may need to be combined. Currently, the ETS Directive makes it is possible for a sector to be included on the carbon leakage list purely on account of its trade intensity or carbon costs. This is may need to be revisited, as it may not be a justifiable approach.

Finally, we reiterate that European Council Conclusions are intended as political direction. This may mean that not every phrase of the Conclusions is translated into legislation. In some cases it may be inevitable to make a choice between the principles outlined in the question. This need not be a bad thing: an EU-level approach for indirect carbon cost compensation – going beyond state aid – may not be disruptive as it ensures a level playing field.

Q1.3 Should free allocation be given from 2021 to 2030 to compensate those carbon costs, which sectors pass through to customers? How could free allocation be best determined in order to avoid windfall profits?

This question could be regarded as addressing two separate issues, which could be, but need not be considered in unison. One issue is that of providing compensation in the form of free allocation to those industries that can pass through costs, resulting in windfall profits. This has been pretty much the case for the electricity industries in earlier ETS phases. The implication is, in our view, that what is up for debate is the method of determining who is at risk of carbon leakage risk - is the current approach working as should, or are there sectors that are 'slipping through'.

The second question could point to the issue of over-allocation, and windfall profits resulting from being allocated too many free allowances. This over-allocation was a result of rigidity of supply both on the auctioning and free allocation sides. On the auctioning side, this rigidity is being addressed by the MSR proposal. The Council Conclusion's reference to a better alignment of future allocations to changes in production levels would address the free allocation side. It is clear that the closer free allocation follows actual production levels, the more windfall profits can be avoided.

The windfall profits arising through cost pass through should also be avoided. The high degree of cost pass-through in the power sector was the reason why that sector fully moved to auctioning as the method of allocation. A surrogate test for the ability to pass-through costs, and the rationale to be included on the carbon leakage list as being at risk of carbon leakage, is trade intensity. It would follow that serious consideration should be given to not having trade intensity as a separate criterion for carbon leakage risk, but to always combine it with another criterion, related to carbon, such as carbon intensity or carbon cost.

One final remark is the fact identifying sectors at risk of carbon leakage seems to be, to some degree, a one-way street, that is sectors have a protocol to get on the list. There is no provision to remove a sector from the carbon leakage list within a trading period, which implies that they may stay there in spite of not conditions changing, and the sector not being at risk anymore.

Chapter 2

Q2.1 Do you see reasons to modify the existing modalities applied in the first two calls of the NER300? Are there any modalities governing the NER 300 programme which could be simplified in the design of the innovation fund? If you see the need for changes, please be specific what aspects you would like to see changed and why.

The current governance structure of the NER300 is marked by a carefully delineated balance of power between the Commission, the Member States and the EIB, with the legislation specifying each of the institutions' roles in high detail. Notably, all three institutions have a role to play as 'gatekeepers' for project selection. This can be explained through the EIB's expertise in project selection, Member States' proximity to project sponsors and the overall role of the Commission in implementing policy.

Currently, there is however not a lot of information available on the decisions process and especially on lessons learned. Whenever projects failed to make the cut, it would be good to have information disclosed on the reasons for why a project did not make it. Such information would aid future project rounds.

The NER300 Decision also specifies in high detail some of the technical and administrative requirements for projects. Given the close scrutiny already exercised by the different institutions (in particular the EIB's due diligence), it could be considered to not put into legislation every detail. This regards details such as the eligible technologies, project timelines and development stages. Instead, the MS and Commission would have some leeway in making their own assessment, with the EIB providing a recommendation.

There is also a strict upper funding threshold in the current Decision of 50%. The justification for this is that a "subsidy race between Member States should be avoided". The 50% threshold, however, leaves a significant share to be provided through other sources. There are some reasons to think that this threshold is too low and that the NER300 should be allowed to fund a higher share of the total costs:

- Other funders, including Member States, may not be willing to put up significant funds given the pre-commercial stage of the projects
- The depressed EUA prices observed throughout the economic crisis lower the total amount of funds available in the programme. This can lead to projects not being supported (the lack of CCS projects in the 1st round is an example) in spite of them otherwise being eligible.

For a programme aimed to boost innovation, strict financial burden-sharing should arguably not be a main driver of project selection. Hence, higher funding thresholds, even up to 100% should be considered.

In relation to this, the selection process also requires a compatibility assessment under state aid rules. The current environmental state aid guidelines have different values for the aid intensity, allowing aid up to 60% (and sometimes higher) of total costs. The funding thresholds could be coordinated more closely with these guidelines.

Additionally, the state aid assessment can be a lengthy process. Given how NER300 projects may be seen as aiding "the execution of an important project of common European interest" (Art. 107 (3b) TFEU), a block exemption could be considered to simplify the selection process.

On the disbursement and monetisation of auctioning revenues, the following observations can be made:

Funds are being disbursed to projects on the basis of specific criteria generally related to realised performance. This leaves funding for capital expenditures to be provided from sources other than the NER300. While Member States have the discretion to allow funding for CAPEX as well, they are generally not enthusiastic to actually do so.

Therefore, the significant sums that may be required ex-ante for these investments may serve as a disincentive for private actors to get engaged with projects. An option could be that the EIB, in its assessment also gives a recommendation on the merits of paying out certain funds upfront.

Finally, when monetising allowances, the EIB is currently strictly required to act as a price-taker. It could be considered to allow the EIB more freedom in determining when to monetise, so that the total amount of funds available would be maximised.

With the significant volatility in EUA prices, the NER has not been able to provide a stable pool of money, especially for the larger projects, including CCS. A mechanism that would make the funds more predictable for such projects is something that should be considered.

Chapter 5

Q5.2 Member States had the possibility to exclude small emitting installations from the EU ETS until 2020. Should this possibility be continued? If so, what should be the modalities for opt-out installations to contribute to emission reductions in a cost-effective and economically efficient manner? Should these be harmonised at EU level?

In the EU ETS, only a small percentage of installations are responsible for the large majority of emissions. 71% of all installations create only 5% of total ETS emissions, while at 84% of the installations, this increases to 10% of emissions. It is therefore easy to see why one would want to exclude small installations from the system, as the administrative costs could be disproportional for small operators. However, small installations are not necessarily operated by small firms. They may be operated by organisations which may also run larger installations, which are, and should clearly remain part of the EU ETS.

It is therefore important that any exclusion remains voluntary for firms. The decision-making process of Member States should also include consultations with the relevant stakeholders. Firms may decide that the alternative measures offered are less attractive than simply adding another installation to the ETS reporting obligations they would face anyway.

The alternative measures for installations not included in the ETS should be harmonised on the EU-level, to prevent distortions of the internal market. Such an alternative measure could be implemented at a more upstream level, such as a charge on fuel use, for which average emission intensity is chosen. Alternatively the inclusion of upstream fuel distributors in the EU ETS, as has been recently implemented in the California ETS starting in January 2015 may be another solution that could be considered.

Clarity and predictability should also be ensured at the beginning of each phase as to what installations are included

Q5.5 Under the current EU ETS Directive, at least 50% of the revenues generated from the auctioning of allowances should be used by Member States for climate-related purposes. For the calendar year 2013 Member States have reported to have used or to plan to use 87 % on average to support domestic investments in climate and energy. Do you consider the current provisions regarding the use of the revenues adequate for financing climate action? If not, please explain why?

Even if Member States currently use more than 50% of auctioning revenue already, the EP recently adopted an amendment in the context of the MSR proposal, which changes the wording from ‘should’ to ‘shall’. There is a desire to ensure that there is always a floor to the percentage of the revenue from auctioning that are used for climate related purposes (which are specified in the Directive)and more specifically into domestic climate action, even if the exact amounts remain unsure due to fluctuating EUA prices.

There are nevertheless other ways in which auctioning revenues can be used, and some of the current provisions regarding the use of revenues may not be optimal from an efficiency point of view. Notably, auctioning revenue could also be used to fund compensation for indirect carbon costs, whether this would be done at a European level or through state aid. The revenues should

also be able to keep up with increased indirect carbon costs, as higher carbon prices also increase the amount of auctioning revenue available.

Using the California model, part of the auctioning revenue could also be used to compensate for cost from indirect emissions. This responsibility could be given to the electrical regulator in each Member State that would have the responsibility to compensate electricity users at risk of carbon leakage for cost from indirect emissions.

At the same time, the current provisions in the ETS Directive refer to auctioning revenue being used, among others, to achieve the Renewable Energy and Energy Efficiency targets. However, any emission reductions achieved through RE and EE improvements in ETS sectors would reduce the demand for EUAs. This ultimately would also reduce the carbon price signal and the revenues raised by auctions. Hence, directing the funds to sectors that are not already addressed by overlapping policies may be a more sensible approach. An important principle should be that the use of funds from auctioning should minimize market distortions.

Instead, the funds could be used to target reductions in non-ETS sectors, or to stimulate investments into industrial low-carbon technologies. It is also important to closely coordinate any provisions on the use of auctioning revenues with those of similar facilities such as the NER300. Whereas the NER300 currently targets specific technologies and development stages, it may be beneficial to allow Member States more freedom to also support other stages and technologies when it comes to auctioning revenues.

An additional point, which should be mentioned, is related to the consistency and transparency of how Member States report on the use of funds from auctioning. This should be examined and improved post 2020. This will show a better picture on which of the elements mentioned in the Directive is money used for, including for assisting countries outside the EU.

Chapter 6

Q6.1 How well do the objectives of the EU ETS Directive correspond to the EU climate policy objectives?

How well is the EU ETS Directive adapted to subsequent technological or scientific changes?

There are different climate policy objectives in the EU, depending on the time horizon applied. These time horizons could be 2020, 2030, or the long-run one of 2050. The different targets, and types of targets, associated with these time horizons, have different degrees of legal certainty and visibility.

The 2020 targets have been implemented in EU legislation, and the EU is on target to reach the GHG reduction target, and the EU-wide RE target, while there is still some uncertainty about the EE target. The 2030 GHG target is not transposed into law yet, but the political direction of the European Council gives it high visibility.

This is different for the long-run target of 80-95% reduction in emissions by 2050, compared to 1990 levels. In principle, the objectives of the EU ETS would become aligned with the EU's climate policy objective, *if* the 2050 target would have clearer visibility, including the operationalization of the 2.2 Linear Reduction Factor (LRF). This updated LRF is indeed part of the Council Conclusions and would put the EU ETS cap on a downward trajectory consistent with the 2050 target of 80-95% reduction.

While implementation of the LRF would improve the visibility of the target, there remains some inherent political uncertainty to such long-run targets, which could always be made responsive to political pressures. This has an impact on the discount factors firms apply to their investments into low-carbon technology. Therefore, when interpreting the EU ETS objectives in a broader way, to include the fact that reductions should take place in the most cost-efficient way, the uncertainty of the 2050 target creates problems.

The EU ETS is also seen as the central pillar in the EU's climate policy. But it is unclear whether it is able to fulfil this central role. The EU ETS should set a price on carbon to drive asset allocation in an economically efficient way. This carbon price signal should drive different changes in different timeframes. In the short-run, the price signal should ensure changes at the operational level by arbitraging between primary energy sources. This, the ETS is able to do well.

In the medium-run, the price signal should drive deployment of low-carbon technology. However, this depends on the credibility, clarity, consistency, and overall level of the price signal. Besides the explicit price signal set by the ETS, there is also the shadow price signal set by other policies such as those set by the RE and EE targets. This shadow price signal blurs the ETS price signal, while at the same time regulatory uncertainty undermines the stability.

The uncertainty of the price signal undermines investment in the development of low-carbon technology and investments that require a high price and a long-term time horizon. As a result, the EU ETS has not been very successful at driving the development of low-carbon technologies, which also makes it hard for it to fulfil the central role in the EU's climate policy.

However, the global climate change policy landscape is currently marked by significant asymmetries in carbon constraints, and the resulting uncertainties associated with it. This will result in concerns over the impact of carbon pricing, and costs, on carbon leakage and competitiveness. While these

asymmetries persist, it will be challenging for the EU ETS to fulfil this central role, and other policy tools in the EU's climate policy mix therefore remain necessary.

However, the two questions need to be examined in light of some other concerns, outlined below. While the difficulty of the ETS to play a central role, as well as other objectives that the is pursuing, justify the RE and EE targets to some extent, these targets also lower demand for EUAs, and thereby affect the efficiency of the ETS. This shows the importance of passing and operationalizing the MSR, which is able to address surpluses irrespective of its source.

When it comes to the adaptability of the ETS to scientific and technological change, the governance of the MSR, and especially the review process, is crucial. This review should identify as much as possible what drove reductions, be it carbon efficiency improvements, including the introduction of new technologies, changes in output levels, or obligations arising due to other policies.

The above should also be reflected in the governance. A rule-based system, totally detached from any review, is not best suited to recognise changes in technology and science. In order to recognize changes in technology and reductions that are due to new technologies and mitigation efforts, the review part of the MSR governance needs to have a mandate to recognize the impact of the introduction of new technologies. These reductions may lead to a surplus and trigger the MSR in the first instance, as they should.

However, post facto analysis should allow for the identification of reductions due to technological changes and ensure that these are not withdrawn from the market. Allowing these reductions to be placed of the MSR would negate the efforts to develop and introduce new abatement technologies and disconnect the ETS from recognizing technological innovation.

Q6.2 What are the strengths and weaknesses of the EU ETS Directive? To what extent has the EU ETS Directive been successful in achieving its objectives to promote emission reductions in a cost-effective manner compared to alternatives, e.g. regulatory standards, taxation?

<u>Strengths:</u>

The strengths of the current ETS Directive is that it is a EU level policy in that it does not create different carbon constraints within the single market.

It ensures the relative certainty of achieving the environmental objective, by embedding a cap with a downward trajectory into the Directive. In this way, cap-and-trade systems such as the ETS are superior to direct carbon taxes, which do not set a specific quota on emissions.

In the current EU ETS, the carbon constraints can be expected to be lenient in times of economic contraction, and stricter in times of economic expansion, as they operate in a counter cyclical manner. This is also different from a tax-based system, where the carbon constraints wouldn't vary with the business cycle.

Additionally, the EU ETS, by its nature, covers all abatement options as it is based on providing a general carbon price signal. This is not different from what a tax would provide, but regulatory standards would clearly lack the same coverage.

In addition it provides a visible and transparent carbon price, which contrasts favourably to shadow carbon prices from renewable energy and energy efficiency programs.

The EU ETS Directive does not specify technological neutrality as a characteristic, but it is implied in a cap-and-trade system, and it is a generally accepted principle. We have however made the case in other questions that provisions within the EU ETS may have the effect of negating this characteristic.

Weaknesses:

A significant weakness in the current ETS Directive is that it does not allow for flexibility on the supply side, both as regards the auctioning schedule, which is fixed, as well as on the free allocation side, which uses historical activity levels and benchmarks to determine allocation levels ex-ante. The fact that the supply of allowances hardly responds to changes in demand for EUAs reduces the efficiency of the system, in particular because large surpluses prevent the price signal from reflecting the long-term scarcity of allowances. One could also argue that the firewall between the ETS and non-ETS sectors is too strong, and that may damage demand flexibility.

On the other hand, the same supply rigidity could also create problems in periods of extended growth, as moving further away from the historical activity levels diminishes the degree to which carbon leakage risk is mitigated.

Lack of flexibility is also a problem where governance of the ETS is concerned. The current ETS Directive contains many important and highly detailed provisions regarding, amongst other things, carbon leakage risk, partial cessation, and allocation modalities. Any changes to these provisions require a laborious process in order to find agreement between the relevant political actors.

The governance should also be able to deal with 'good surpluses' and 'bad surpluses'. While it is clear that surpluses arising due to supply rigidity and reduced economic output undermine the efficiency of the ETS, surpluses arising due to technological advancements should arguably be treated differently. Failing to do so would undermine the incentive to keep investing in such low-carbon technologies.

Under the first carbon leakage list, 95% of industrial emissions in the EU ETS were included. Post 2020, this cannot continue in its current form as the number of free allowances will decline and consequently there will not be enough of them. Therefore, a different approach will need to be with respect to identifying those at risk of carbon leakage. Secondly, with respect to this issue, free allocation is an approach that will have a finite shelf life as provide free allocation and a more limited incentive for abatement to a large part of industrial emissions is not sustainable in the long term. An international cooperative approach is inevitable and will need to be developed in the mid-to-long term.

A final weakness noted already in other questions is the lack of visibility of the long-term decarbonisation target. Because shorter term targets are seen as more certain and more visible, firms only take into account the short-term marginal costs of carbon when planning their investments. However, to make the ETS function most cost effectively it would be necessary that firms take into account the long-term marginal costs in their planning.

The ETS in relation to alternative policies:

The identified weaknesses do not mean that an ETS is not a suitable policy tool for EU climate policy. In fact, many of the complications the ETS Directive now needs to address to mitigate carbon leakage risk would also need to be addressed in a tax-based or regulatory standard policy design, as all policies would involve costs to stakeholders.

At the same time, these alternatives lack some of the attractions of an ETS, such as the possibility to trade allowances, putting a uniform price signal on carbon throughout the economy, and ensuring that, in principle, the cap is met. Any weaknesses of the ETS are therefore rather a reason to reform the Directive, but not to abandon it.

The question is not if we need to introduce structural reforms to the EU ETS, but what should their nature be: evolutionary or revolutionary? So far, the approaches that have been introduced have been more evolutionary in nature, but there are voices asking for a more fundamental redrawing of the EU ETS.

Q6.3 To what extent are the costs resulting from the implementation of the EU ETS Directive proportionate to the results/benefits that have been achieved, including secondary impacts on financing/support mechanisms for low carbon technologies, administrative cost, employment impacts etc.? If there are significant differences in costs (or benefits) between Member States, what is causing them?

A substantial degree of the costs of implementation are, in CEPS' view, related to the measures on carbon leakage risk mitigation. The administrative costs, while always an item to keep an eye on, are not seen as a barrier, and would not vary greatly, should a different way to price carbon be introduced.

With auctioning being, in principle, the go-to method of allocation in EU ETS Phase 3, any allowances which are still given away for free, represent a cost to Member States due to the foregone auctioning revenue. The proportionality of these costs depends on the degree to which the carbon leakage risk mitigation measures have targeted those that are truly at risk of carbon leakage, and in a manner that is effective.

During ETS Phase 3 so far, these measures have been effective. The measures have been designed assuming a carbon price of 30 EUR per EUA, but in reality allowance prices have been much lower. A major reason for these depressed allowance prices, however, is the impact of the economic crisis on output, combined with the supply rigidity using historical, pre-crisis activity levels.

At the same time, the fixed free allocation has been overly generous during phases 1 & 2, resulting in many firms receiving more allowances than they required covering their emissions. This represents an unnecessary cost to Member States, with Member States who have seen output drop the most, also bearing most of the costs.

In a situation where there would have not been an economic crisis, or where economic output expands again, the current carbon leakage risk mitigation measures would be insufficient however. Combined with the impact of the CSCF, the exposure of sectors on the carbon leakage-list to carbon

leakage could increase over time. If carbon leakage would actually take place, or increase this represents a major cost as with obvious negative effects on employment and the environment.

The impact of overly generous free allocation also has negative secondary consequences on the financing and support mechanisms. As noted in response to another question in this questionnaire, Member States on average used 87% of the proceeds of auctioning for domestic climate related purposes. Had there been fewer allowances given away for free, both auction numbers and revenues could have been higher. This would have allowed for more investments into low-carbon technology, which is necessary to achieve the long-term decarbonisation targets of the EU's climate policy. This needs to be seen in the context of ensuring that what is needed for mitigating carbon leakage risk is available, but that no over-allocation takes place.

The primary difference in costs between Member States would arise due to the lack of harmonisation of indirect carbon cost compensation. The discretionary state aid method for this compensation puts the burden on the fiscal capacities of Member States, which vary greatly and have also been affected to different extents by the economic crisis. The fact that energy mixes differ greatly per Member State, and with it indirect carbon costs, exacerbates this effect.

Q6.4 How well does the EU ETS Directive fit with other relevant EU legislation?

One of the promises of cap-and-trade systems is that they will deliver once the environmental cap or objective is set. In the EU the EU ETS has been designed to be the main climate change too. Cap-and-trade tends to work well when given a focus and target to deliver. If operationalized together with other measures targeting the same sectors also covered by the ETS, these other measures are likely to have a secondary impact on the price signal given by the ETS.

This is principally being observed through the presence of the targets for Renewable Energy and Energy Efficiency, which form the other two pillars of the EU's Energy and Climate framework. Besides weakening the ETS price signal due to reduced demand for allowances, high RE and EE targets make it harder for the ETS to play a central role in the EU climate policy framework.

There are, however, good reasons to maintain the policy mix. Due to the global asymmetries in carbon constraints and the associated necessity of mitigating carbon leakage risk, it is already harder for the ETS to play the central role, in all time frames, under the current global landscape. Additionally, other policies may have other objectives as well. Higher RE targets benefit energy security, while EE targets may help cushion the impact of potentially increased energy prices.

The interaction with the ETS price signal remains however. While the Commission's Impact Assessment recognises this interaction, it also does not go beyond stating that the GHG reduction target has been set taking into account this effect from overlapping policies. A higher degree of transparency and justification of the primary targets in the climate policy mix would be useful: what would the GHG reduction target have looked like given certain other values for RE and EE?

A similar thing may be said for other policies which interact with the ETS. Directly or indirectly, legislation on Fuel Quality, CCS, Eco-design, Large Combustion Plants, Energy Performance of Buildings may affect EUA demand. In order to better assess interactions, the legislation should explicitly address what market failure or other policy objective would justify the overlap with the ETS.

Finally, it should be noted that any adverse interaction with the ETS price signal has been exacerbated by the allowance supply rigidity noted in other answers to this consultation. This again makes the case for the Market Stability Reserve, as this mechanism will be able to deal with all surpluses, irrespective of its source.

Q6.5 What is the EU value-added of the EU ETS Directive? To what extent could the changes brought by the EU ETS Directive have been achieved by national measures only?

In a single market it is naturally beneficial to have a uniform price signal for carbon throughout the economy. Different carbon price signals, which would emerge from national climate policies, would distort the internal market.

The EU ETS has started in a more decentralized way and has been centralizing many of its functions, due to a number of causes, including security, efficiency, costs, etc. The problems with over-allocation during EU ETS Phase 2 show the risks that a decentralised, Member State level implementation can bring. Having National Allocation Plans without a high degree of harmonisation of allocation rules creates perverse incentives to allocate more allowances than necessary, for fear of damaging the competitive position of a Member State's own firms.

In EU ETS Phase 3, the uneven playing field for indirect carbon cost compensation through discretionary state aid measures, further shows the distortive effects a decentralised system could bring.

Subsidiarity should therefore not be seen as a concern as far as the EU ETS is concerned. In fact, the principle can also be a reason to regulate more at the EU-level, if national measures prove insufficient to achieve the objectives of a policy.

The EU ETS has brought changes to the way industry operates, and how society looks upon the value of emitting a ton of CO2e. Some of these changes could have been achieved through national measures, but at a cost. The 2020 package, and other reasons, have triggered expensive measures at the Member State level. Running different regulatory systems with different approaches would certainly only add to the costs and damage competitiveness.

The efficacy of an EU wide system, with many marginal abatement costs, is one advantage that the EU brings. The deepness of the market at the EU level is obvious. It is unlikely that any particular MS can run a liquid enough market on its own, and as such there is a choice between not having an ETS, or having to link national ETSs. This is a much more complex proposition, with more opportunities for arbitrage, and therefore reduced economic efficiency.