



Analysis of Europe's  
2030 Climate  
Ambition

31 October 2014

## Introduction

During the night of 23 October 2014, EU leaders have brokered a deal on the 2030 climate and energy headline targets. EU's Heads of States settled on an EU-binding renewable energy target of at least 27%, an indicative energy efficiency target of at least 27% and an at least 40% binding domestic greenhouse gas reduction target by 2030.

This deal setting out Europe's future climate ambition has to be seen in the wider political context of the international climate negotiations that are expected to deliver a global climate deal at the climate summit in Paris next year. The EU is one of the first in announcing its pledge for the future climate treaty, providing momentum for the rest of the world to follow suit. However, the EU's climate target fails to be in line with the EU's fair contribution to tackling climate change which would entail around 55% domestic emission cuts. This lack of ambition is largely caused by the current difficult political and economic climate landscape: The economic crisis has reduced the political willingness to adopt policies that are either seen as expensive or have a potential impact on industry's competitiveness. Euroscepticism, on the other hand, has put a strain on the regulatory powers of the EU, favoring an (over)reliance on markets instead.

Although the 2030 climate and energy package is centered around the greenhouse gas reduction target with little support from the renewable energy and energy efficiency pillars, a positive decision was to keep the option open of increasing the 2030 climate target at a later stage. But this outcome which required all 28 Member States to agree came at a price: Concessions were made to some countries in the form of energy subsidies and new flexibility instruments. Poland was the most vocal country threatening to use its veto to block the deal in case it was not sufficiently compensated financially. Poland succeeded in ensuring that its coal-dominated energy sector will remain shielded from the carbon price also in the future. Poland also ensured access to new subsidies by establishing a modernization fund that could potentially be used to extend the lifespan of its existing coal power plants. At the same, more wealthy countries with relatively high national reduction targets demanded new flexibility instruments to make sure they would not be faced with high costs. A new flexibility option was borne that allows these countries to buy allowances from the oversupplied carbon market in order to offset emissions in the transport, building and agriculture sectors.

In a nutshell, key highlights of decisions on the 2030 climate and energy framework include:

1. A binding target to reduce domestic greenhouse gas emissions by at least 40% by 2030, possibly resulting in only 31% effective emission reductions
2. A possible revision of the EU's pledge after the climate summit in Paris next year, opening doors for the EU to increase its climate ambition and participate in the international carbon market
3. Flexibilities to help achieve Member States' targets for the non-ETS sectors, including offsetting non-ETS emissions with EU ETS allowances
4. Continuation of free allocation of emission allowances to industry, worth €120-€300 billion
5. Inclusion of land use, land use change and forestry (LULUCF) into the climate framework
6. Financial support to the power sector in low-income states, including free allowances to power plants worth up to €11-€16.5 billion and a modernization fund worth €6-€9 billion

See below a more detailed analysis of these decisions and possible next steps:

## 1. A binding target to reduce domestic greenhouse gas emissions by at least 40% by 2030

The 2030 council conclusions read:

**2. The European Council endorsed a binding EU target of an at least 40% domestic reduction in greenhouse gas emissions by 2030 compared to 1990. To that end:**

**2.1 the target will be delivered collectively by the EU in the most cost-effective manner possible, with the reductions in the ETS and the non-ETS sectors amounting to 43% and 30% by 2030 compared to 2005, respectively;**

**2.2 all Member States will participate in this effort, balancing considerations of fairness and solidarity;**

**2.3 a well-functioning, reformed Emissions Trading System (ETS) with an instrument to stabilize the market in line with the Commission proposal will be the main European instrument to achieve this target; the annual factor to reduce the cap on the maximum permitted emissions will be changed from 1.74% to 2.2% from 2021 onwards;**

### Impact of surplus on the 40% target

Up to 4.5 billion excess emission permits in the EU's carbon market

Europe's carbon market is currently not functioning properly due to an oversupply of emission allowances equaling more than 2 billion, which has depressed the carbon price to a historic low level. By 2020, the surplus is expected to accumulate to 2.6-4.5 billion excess emission permits<sup>1</sup>. The surplus is the result of a combination of factors, including the large inflow of international carbon offset, EU's weak 2020 target that is out of line with a least cost pathway to achieve the 2050 decarbonisation objective and the economic recession.

EU leaders decided that the EU's Emissions Trading System with a Market Stability Reserve will be the "main instrument" to achieve the 2030 climate target, but failed to call for permanent removal of the excess emission permits by 2020. The 2.6-4.5 billion surplus under the EU ETS could sabotage Europe's climate efforts for decades to come, as the excess allowances are automatically carried-over into the 2030 climate framework. This could contaminate the proposed 40% climate target by watering down the effective reduction to only 24%-31%. The graph on the right by [Carbon Brief](#) explains how the surplus of carbon allowances could lead to increased 2030 emissions.



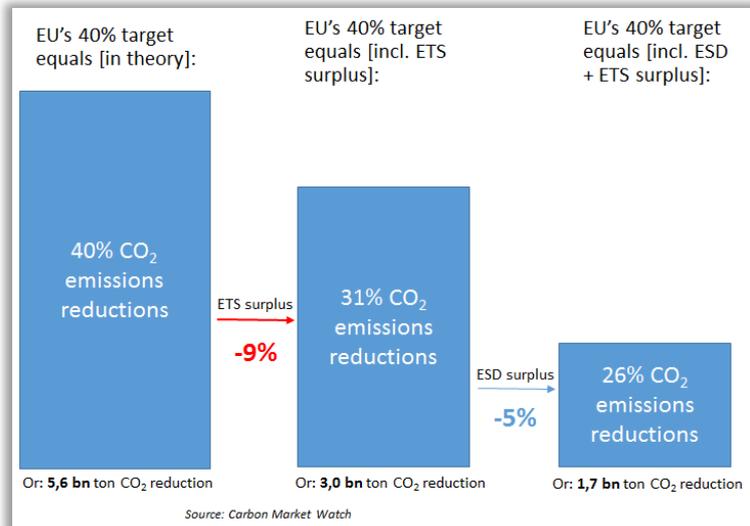
### 1.3 billion surplus emission permits in EU countries

In addition to the surplus accumulated under the EU ETS, a considerable amount of excess emission allowances under the Effort Sharing Decision (ESD) will also build up in the current climate framework. The ESD, EU's second climate instrument, sets out yearly reduction targets for each country for those

<sup>1</sup> The [European Commission](#) (2014) estimates that the surplus will reach 2.6 billion allowances by 2020. More recent estimates by the [UK government](#) (2014) and [Sandbag](#) (2014) show an even higher oversupply of 3.1 and 4.5 billion allowances by 2020.

sectors not covered by the EU ETS and as such, covers more than 60% of the EU's emissions. By the year 2020, European countries are expected to have accumulated around 1.3 billion unused allowances under the ESD. This is due to two reasons:

- (i) The weak 2020 targets leading to a surplus of around 600 million tonnes of CO<sub>2</sub>-eq<sup>2</sup> as actual greenhouse gas emissions are predicted to remain below the EU's targets in each year during the 2013-2020 period.
- (ii) The use of up to 750 million international offsets until 2020<sup>3</sup>, since EU Member States can purchase more than half of their overall reduction obligations through carbon credits from offsetting projects in developing countries.



Contrary to the surplus emission allowances under the EU ETS, which will be carried-over automatically, the ESD does not foresee banking of these pre-2020 surplus allowances for future use, unless explicitly decided otherwise. The Council conclusions don't explicitly open doors for this option which can be interpreted as a very welcome step to safeguard the 2030 target from an additional loophole on top of the excess allowances from the EU ETS.

There was a considerable threat that the EU leaders would decide to allow banking of pre-2020 surplus allowances, because several countries, such as Poland, Hungary, Czech Republic, Slovakia, Bulgaria and Romania actively advocated for this. These countries, commonly referred to as "Visegrad+2 countries", are projected to overachieve their 2020 targets, leaving them with a considerable amount of unused pre-2020 allowances. Allowing them and the other EU countries to use these "rights to pollute" in the 2030 climate framework, would have watered down the 2030 climate target by 5%.

### Postponing most of the climate action until later

The European Council reconfirmed in February 2011 the EU's objective of reducing greenhouse gas emissions by 80-95% by 2050 compared to 1990. Today's decision by the EU leaders calls for a 40% reduction of greenhouse gas emissions between the 1990-2030 period and a further 40% emission reduction between the period 2030-2050. See also the graph on the right by [Ecofys](#) (2014) showing that the 2030 climate target of 40% is not on a linear reduction pathway from 2020 to 2050. In other words: under the proposed emission reductions of 40% or less by 2030, efforts need to heavily accelerate after 2030 to

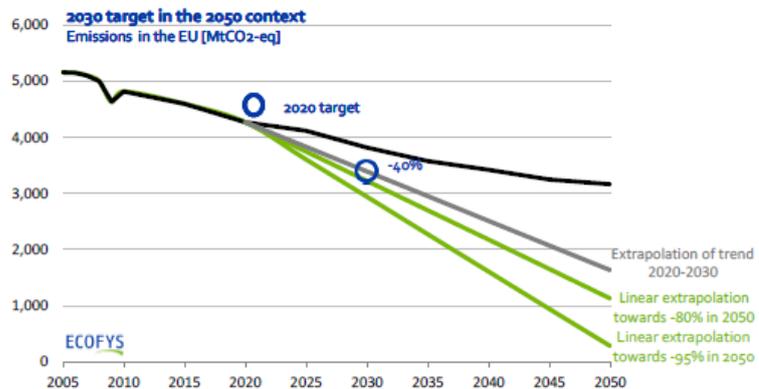


Figure 1 Emission pathways towards 2050, the 2020 target and the 40% for 2030.

<sup>2</sup> European Commission (April 2014), Technical Annex to Kyoto Ambition Mechanism Report

<sup>3</sup> European Environment Agency (2013). [Trends and projections in Europe 2013](#)

achieve 80-95% emission reductions by 2050. Most of the climate action is hence postponed until later as the average annual reduction effort has to double in the period 2030-2050 compared to 2010-2030.

### Next steps

At the beginning of this year, the European Commission proposed to establish a Market Stability Reserve to address the problems with the oversupplied carbon market. It is now in the hands of the European Parliament and the Council to amend and agree on this legislative proposal.

In the course of 2015, the European Commission is furthermore expected to come forward with legislation to implement the 2030 climate target, in particular:

- **A proposal to revise the EU ETS directive** to implement the 2030 target for the ETS sectors, including a proposal to increase the linear reduction factor by which the cap on ETS emissions is reduced each year.
- **A proposal for new legislation that specifies the annual binding targets for the non-ETS sectors** in each country to implement the 2030 target.

### Carbon Market Watch Recommendations

#### For the EU ETS revision:

- The **linear reduction factor** by which the cap on EU ETS emissions is reduced each year will need to increase to **2.6% or more**<sup>4</sup> to bring the EU's 2030 climate target in line with a linear pathway to the objective to reduce greenhouse gas emissions by 80-95% by 2050.
- The **next trading period** of the EU ETS needs to be **shortened to 5 years** (2021-2025) so as to avoid locking in the EU in a high-carbon pathway for years to come.

#### For the new legislation governing the emissions of the non-ETS sectors:

- The annual reduction of the overall **cap on non-ETS emissions** needs to be made **consistent with a linear reduction pathway** to the objective to reduce greenhouse gas emissions by 80-95% by 2050.

#### For the Market Stability Reserve proposal:

- **The surplus emission allowances under the EU ETS needs to be permanently removed** in order to ensure that the proposed 40% climate target is not watered down.

## 2. Possible revision of EU's climate pledge after the 2015 climate summit

The 2030 council conclusions read:

**1. [...] On the basis of the principles identified in the March 2014 European Council conclusions, the European Council agreed today on the 2030 climate and energy framework for the European Union. Accordingly, the EU will submit its contribution, at the latest by the first quarter of 2015, in line with the timeline agreed by the UNFCCC in Warsaw for the conclusion of a global climate agreement. The European Council calls on all countries to come forward with ambitious targets and policies well in advance of the Conference of the Parties 21 in Paris. It will revert to this issue after the Paris Conference. [...]**

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<sup>4</sup> See Carbon Market Watch's [policy briefing](#) on the EU ETS.

## The role of the EU at international climate negotiations

EU leaders kept doors open to revise the EU's pledge after the climate summit in Paris next year where a future international climate treaty to replace the Kyoto Protocol is expected. The world has been watching the EU as it is the first major emitter to come forward with a climate target. The decision therefore provides some momentum towards the Paris 2015 global climate agreement. However, the EU's proposed climate target is not in line with the EU's fair contribution to tackling climate change<sup>5</sup> which would be in the order of at least 55% greenhouse gas emission reductions. Scaling up climate ambition is therefore necessary in the near future to be able to limit global warming below 2°C. The decision to possibly increase the EU's climate target in the context of the international climate negotiations is hence an important and much hoped for element in the package.

## Future prospects of linking emissions trading systems

Despite moving away from allowing international offsets as part of the 40% GHG target, the EU is still dedicated to establish a global carbon market and is heavily involved in various initiatives, including the World Bank's Partnership for Market Readiness.

The possible revision of the EU's climate target beyond 40% emission reductions therefore also has to be seen within this context as it opens up a future EU role in global carbon markets. This is an important element for certain EU countries that have historically had a high stake in carbon markets, such as Germany, the UK, Sweden, the Netherlands and others who have explicitly stated in the international climate negotiations that a liquid international carbon market with sufficient demand can promote cost-effective abatement and stimulate mitigation ambition towards our shared 2°C objective. Opening doors for the EU to remain a player in international carbon markets is also seen by some countries as an important element in their international relations with third countries.

The EU and Switzerland are currently negotiating the possibility of linking their emissions trading systems. At the same time, more and more countries have implemented or are in the process of implementing an emissions trading scheme. China for example expects to roll-out a national carbon market by 2016.

Linking the EU's carbon market with emissions trading schemes outside of Europe opens the question how these "foreign" allowances are to be treated as part of Europe's 40% GHG target. Although the nature of the GHG target has been decided as "domestic", some stakeholders have implied that linking of carbon markets could fall within the scope of the 40% GHG target.

## Future role of international UNFCCC market mechanisms in the EU

In the run up to the 2015 Paris climate negotiations, international carbon market rules are being negotiated at international level. The EU is particularly active in establishing a New Market Mechanism (NMM) and a so called Framework for Various Approaches (FVA) which is expected to put rules in place for the transfer of emission units between different emissions trading schemes and offset markets. Next to the importance of setting up an international accounting framework to avoid double counting, a key issue is to agree on criteria and in particular on the level of ambition to allow countries to use markets to count towards their commitments.

There is a common understanding that the EU's domestic 40% climate target does not provide sufficient momentum to create demand for new market mechanisms for two reasons: 1) 40% is not in line with EU's linear decarbonisation pathway up to 2050 and hence does not set a positive step that could be considered as "ambitious" 2) it excludes the use of international carbon offsets, units or allowances by establishing a binding domestic GHG target.

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<sup>5</sup> See [Ecofys](#) (2014), Assessing the EU 2030 Climate and Energy targets: A briefing paper

Therefore those EU Member States that want to be able to use international carbon units (from existing Kyoto offsetting mechanisms or the new market mechanism) have an interest in increasing EU's domestic 40% target. For more information on the current experience of the use of international offsets in EU's 2020 climate legislation see our [policy briefing](#).

### Next steps

As part of the international climate negotiations, the European Parliament, the Council and the European Commission will discuss increasing EU's climate ambition beyond the 40% domestic reductions.

Furthermore, the negotiations on linking the EU ETS with the Swiss ETS are still ongoing and might be finalized in the next year(s).

### Carbon Market Watch Recommendations

- The EU should adopt a **climate target of at least 55% domestic emission reductions by 2030**. The EU's international leadership role will depend on meaningful steps to increase ambition ahead of this Paris climate summit. Increasing Europe's climate ambition ahead of this climate summit could incentivize other countries to step up their climate efforts too, leading to a race to the top that could increase our chances of avoiding dangerous climate change.

#### As part of the EU ETS revision:

- The EU ETS directive should **include linking safeguards** to ensure that linking does not compromise the domestic nature and the integrity of the EU's 2030 climate target. Unless the foreign carbon market fully complies with all the rules and the ambition level of the EU ETS, allowing the use of allowances from a non-EU country for compliance under the EU ETS should not fall within the scope of EU's "domestic" emission reductions. The European Parliament should furthermore also be involved in the discussion around linking the EU ETS with other carbon markets: Currently the European Commission negotiates linking with other emissions trading systems on the Council's behalf.

## 3. Flexibilities to help achieve Member States' targets for the non-ETS sectors

The 2030 council conclusions read:

***2.12 the availability and use of existing flexibility instruments within the non-ETS sectors will be significantly enhanced in order to ensure cost-effectiveness of the collective EU effort and convergence of emissions per capita by 2030. A new flexibility in achieving targets – for Member States with national reduction targets significantly above both the EU average and their cost-effective reduction potential as well as for Member States that did not have free allocation for industrial installations in 2013 – will be established through a limited, one-off, reduction of the ETS allowances, to be decided before 2020, while preserving predictability and environmental integrity;***

Countries fear the relatively high costs for meeting their 2030 reductions required in sectors not covered by the EU's ETS, such as transport, agriculture, buildings and waste. This is especially the case for those countries with a relatively high economic output per inhabitant, as the efforts of the 2030 target will be distributed on the basis of relative Gross Domestic Product (GDP) per capita. This basically means that more wealthy countries will be faced with more ambitious climate targets than poorer ones. The national 2030 targets for each country will span from 0% to -40% compared to 2005, and adjusted for Member States with a GDP per capita above the EU average to also reflect cost-effectiveness.

The use of flexibilities could help Member States to reach their climate targets against less costs. But contrary to the existing 2020 climate target, the new 2030 climate target does not allow for the use of international offsets from reductions in developing countries. To compensate for the lack of international flexibilities, EU's leaders settled on enhancing the current intra-EU trading options by allowing transfers between Member States and sectors to ensure that the most cost-effective mitigation measures are taken first.

### The use of EU ETS allowances to meet non-ETS climate targets

EU leaders agreed that Member States with relatively high national reduction targets<sup>6</sup> as well as Member States without free allocation to industrial installations in 2013<sup>7</sup> should be allowed to use EU ETS allowances in order to meet their non-ETS climate targets.

This flexibility was requested by countries that expected to have difficulties reducing their emissions in the transport and agriculture sectors, since measures to reduce CO<sub>2</sub> emissions in these sectors could be relatively expensive or face public resistance. In practice, this would mean that the total amount of allowances under the EU ETS would be reduced, so that these allowances can be used to offset emissions in the non-ETS sectors.

However, allowing certain countries to use EU ETS allowances to count for non-ETS sector reductions could be counterproductive. The lower auctioning revenues of these governments, as a result of reduced auctioning volumes of ETS allowances, effectively reduces public resources that could otherwise be spent on mitigation efforts like improved public transportation systems or better insulated houses. Depending on the exact limit on how much ETS allowances can be used, this flexibility could reduce the incentives for emission reductions in the non-ETS sectors, potentially jeopardizing mitigation efforts in the building, transport, agriculture and waste sectors. This is because the price of ETS allowances (around €6/tCO<sub>2</sub>-eq) is much lower than the carbon price required to enable reductions in the transport and agriculture sectors. This flexibility also reduces the demand for domestic offsets from poorer EU countries.

### Introduction of a domestic offsetting mechanism

EU leaders also agreed that the existing flexibility instruments within the non-ETS sectors should be enhanced. Under the current 2020 climate framework, the Effort Sharing Decision that covers the non-ETS emissions include inter-temporal flexibilities (the possibility for Member States to shift their reduction effort between compliance years) as well as the flexibility to transfer allowances to another Member State. EU leaders propose to improve the latter flexibility instrument “in order to ensure cost-effectiveness of the collective EU effort and convergence of emissions per capita by 2030”. Since most of the cost-effective emission reductions are located in the lower income Member State, transfers between Member States can unlock this mitigation potential leading to cost-effectiveness of the collective EU effort.

The council conclusions suggest to “significantly enhance” the transfers of allowances between Member States, since currently there is a lack of harmonized modalities for these transactions. Enactment of a project-based domestic offsetting mechanism can provide for these harmonized modalities. Domestic offsets could help in providing financial revenues for energy-saving projects in poorer Member States where there is still a large potential for cost-effective mitigation measures.

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<sup>6</sup> Probably including countries like Denmark, Luxembourg, Ireland etc.

<sup>7</sup> This includes Malta, see [here](#).

## Next steps

The European Commission is expected to present the following legislative proposals in the course of 2015:

- **New legislation governing non-ETS emissions**, including the detailed proposals about flexibility mechanisms (e.g. which countries qualify, how much EU ETS allowances can be used, details about the domestic offsetting mechanism),
- **An amendment to the EU ETS directive** that allows Member States to reduce their auctioning volumes. Currently Article 10(1) of the ETS directive makes it impossible for Member States to do this.

## Carbon Market Watch Recommendations

- The new flexibility mechanism should be as **limited in scope** as possible, by significantly restricting the Member States that would qualify as well as the amount of EU ETS allowances that could be used for compliance under the legislation governing non-ETS emissions.
- The amendment to the EU ETS directive should be extended to also **allow Member States**, which wish to tackle the oversupply in EU's carbon market, **to permanently cancel surplus** emissions allowances through a reduction of their auctioning volumes.

## 4. Continuation of free allocation of emission allowances to industry

The 2030 council conclusions read:

**2.4 free allocation will not expire; existing measures will continue after 2020 to prevent the risk of carbon leakage due to climate policy, as long as no comparable efforts are undertaken in other major economies, with the objective of providing appropriate levels of support for sectors at risk of losing international competitiveness. The benchmarks for free allocations will be periodically reviewed in line with technological progress in the respective industry sectors. Both direct and indirect carbon costs will be taken into account, in line with the EU state aid rules so as to ensure a level-playing field. In order to maintain international competitiveness, the most efficient installations in these sectors should not face undue carbon costs leading to carbon leakage. Future allocations will ensure better alignment with changing production levels in different sectors. At the same, incentives for industry to innovate will be fully preserved and administrative complexity will not be increased. The consideration to ensure affordable energy prices and avoid windfall profits will be taken into account;**

**2.6 the existing NER300 facility will be renewed, including for carbon capture and storage and renewables, with the scope extended to low carbon innovation in industrial sectors and the initial endowment increased to 400 million allowances (NER400). Investment projects in all Member States, including small-scale projects will be eligible;**

The EU ETS covers just over 40% of the EU's greenhouse gas emissions from the industry and power sector. After each year, companies participating in the system must surrender enough allowances to cover all of their emissions. For the 3<sup>rd</sup> trading phase from 2012 to 2020 companies are supposed to purchase their emission allowances under the EU ETS through auctioning as the default allocation method. However, the production from European industrial sectors that is deemed to be exposed to a

significant risk of “carbon leakage”<sup>8</sup> is getting protection by receiving their allowances to emit CO<sub>2</sub> for free. This concept has been adopted during the previous revision of the EU ETS and is valid for the 2020 climate package from 2013 to 2020. Currently more than 97% of industry’s emissions are covered by 100% free allocation of emissions allowances up to the benchmark<sup>9</sup>, representing a value of €40 billion during the period 2015-2019.

Furthermore, as part of the 2020 climate framework, 300 million allowances are set aside in a reserve (the NER300) in order to finance carbon capture and storage and innovative renewable energy projects in the EU.

### Continued free pollution permits worth €120-€300 billion

EU leaders agreed to continue with subsidies to manufacturing industries in the form of free polluting permits to address the potential risk of carbon leakage. While agreeing to continue with free allocation of emission allowances to industry, EU leaders also indicated certain changes to the way these allowances will be handed out in the future. They suggest that:

- The amount of free allowances to industry should in the future not only cover direct carbon costs, but also the **indirect costs** of higher power prices.
- **The benchmarks should be periodically updated** so the allocation of free emission allowances is based on the latest technological progress in the industry sectors.
- Future allocation should not be based on historic production levels, but be better aligned with the **changing production levels**. This could be a reference to the proposal of “dynamic allocation”<sup>10</sup> as suggested by the Dutch government and several industrial sectors, although dynamic allocation can increase administrative complexity while the conclusions call against this.
- The most efficient installations should not face “undue” carbon costs. This could be a reference to **removal of the cross-sectoral correction factor**, as argued for by several industrial sectors. In the current framework, the correction factor ensures that the total amount of free allowances to industry is capped. Removal of the correction factor will mean that there is no more limit on the number of free allowances to industry, potentially lowering amounts of allowances available for auction, which could increase the carbon price. As the power sector needs to buy all of their allowances at auction, this might lead to higher energy prices. It could also lead to an increase in windfall profits that are the result of industrial companies passing on the carbon price to consumers while receiving the carbon permits for free themselves. Reading the conclusions, it appears that Member States are divided on this point. While hinting at removal of the correction factor, the conclusions also suggest that affordable energy prices and avoiding windfall profits will be taken into account.

Continuing with the current practice means that around 6 billion allowances will be freely allocated in the period 2021-2030<sup>11</sup>, representing a value of around €120-€180 billion<sup>12</sup>. When the cap on the total

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<sup>8</sup> Carbon leakage is the situation in which, as a result of stringent climate policies, companies move their production abroad to countries with less ambitious climate measures to lower their production costs. This can lead to a rise in global greenhouse gas emissions. A recent study ordered by the European Commission found that during 2005-2012 there were no occurrences of carbon leakage.

<sup>9</sup> The benchmark is the threshold for what an installation gets for free. The starting point for setting the benchmark values is the average performance of the 10% most efficient installations in the (sub)sector. The benchmark (ton CO<sub>2</sub> per ton product) is then multiplied by the average historical production during 2005-2009 to get to the amount of free allocation the installation receives.

<sup>10</sup> See also Carbon Market Watch’s short [briefing](#) on dynamic allocation.

<sup>11</sup> In case the current situation continues, e.g. extrapolating the cross-sectoral correction factors up to 2020 into the future.

<sup>12</sup> Assuming a carbon price of between €20 and €30.

amount of free allowances is removed, the subsidy to industry could be increased from €40 billion during 2015-2019 to a total of €200-€300 billion<sup>13</sup> during 2021-2030.

### The fund for low-carbon technologies and innovations worth €8-€12 billion

EU leaders also decided to establish a new fund to finance low-carbon technologies and innovations. They indicated that this reserve (the “NER400”) should contain 400 million allowances, which is 100 million allowances more than the fund established as part of the 2020 climate framework. The scope of the fund is furthermore extended to also cover climate innovations in industrial sectors. But the money available (€8-€12 billion<sup>14</sup>) will be much less than the value of the free allowances to cover for industry’s pollution (€120-€300 billion).

### Next steps

We expect the European Commission to next year come forward with:

- **New provisions to address the potential risk of carbon leakage** for Europe’s industrial sectors.
- **A proposal for a new reserve (NER400)** in which 400 million allowances will be set-aside to fund renewable energy projects and low-carbon innovations in industrial sectors.

Both will be part of the revision of the EU ETS in order to implement the 2030 climate target.

### Carbon Market Watch Recommendations

- The new provisions to address the potential risk of carbon leakage should combine **full auctioning of emissions allowances** with border levelling of carbon costs or investment support for technologies that reduce emissions. The current experience with free allocation of allowances is that industry is not receiving a sufficient price signal to produce more efficiently while investments in innovative technologies to reduce CO<sub>2</sub> are not supported. The new provisions should furthermore be reviewed in the context of a global climate deal agreed at the climate summit in Paris next year.
- The **new reserve should be enlarged into a NER1000 reserve** in which 1 billion allowances are set-aside to be used to fund renewable energy projects and low-carbon innovations that are needed to achieve deep emission reductions in the industrial sectors.

## 5. Inclusion of land use, land use change and forestry (LULUCF) into the climate framework

The 2030 council conclusions read:

***2.14 the multiple objectives of the agriculture and land use sector, with their lower mitigation potential, should be acknowledged, as well as the need to ensure coherence between the EU’s food security and climate change objectives. The European Council invites the Commission to examine the best means of encouraging the sustainable intensification of food production, while optimizing the sector’s contribution to greenhouse gas mitigation and sequestration, including through afforestation. Policy on how to include Land Use, Land Use Change and Forestry into the 2030 greenhouse gas mitigation framework will be established as soon as technical conditions allow and in any case before 2020.***

<sup>13</sup> Again, assuming a carbon price of between €20 and €30. [Ecofys](#) (2014) has showed that if the correction factor is removed and industry is also compensated for indirect costs, industry will receive 4 billion free allowances more than under current carbon leakage rules during 2021-2030.

<sup>14</sup> Assuming a carbon price of between €20 and €30.

Currently, the CO<sub>2</sub> emissions and removals from agriculture and land use, land use change and forestry (LULUCF) are excluded from EU's 2020 climate target. However, in order to tackle climate change all sectors should contribute to the mitigation efforts in the future, including the climate impact of the agriculture and the LULUCF sector. The Heads of State have invited the Commission to look into the best ways of ensuring that also the LULUCF sector contributes to greenhouse gas mitigation and increased sequestration.

The results of a recent Commission's impact assessment has shown that a separate framework for LULUCF is the preferred option to tackle the sector's climate impact and to ensure the integrity of the EU's climate framework. Because the LULUCF sector is fundamentally different from the sectors currently subject to EU's climate legislation, due to its inherent characteristics such as non-permanence, data uncertainties and inter-annual variability, it seems unfit for inclusion in the current climate laws.

Previous drafts of the council conclusions also indicated that certain countries should be allowed to offset agriculture emissions with afforestation projects. This option appeared to have been included at the request of Ireland, which has a large agriculture sector. The final council conclusions however only include a very implicit reference when mentioning in one sentence both intensification of food production and optimized sequestration "including through afforestation".

### Next steps

- The European Commission is expected to come forward with new legislation how to tackle the climate impact of the LULUCF sector before 2020.

### Carbon Market Watch Recommendations

- The **LULUCF sector is best placed in a separate pillar**, since the sector's characteristics (annual fluctuations, long-time horizons, uncertain data reliability) make the sector unfit for inclusion in the legislation covering the non-ETS emissions that requires annual compliance.
- Tackling the climate impact of the LULUCF sector should be **additional to the mitigation efforts in other sectors** and can thereby enhance the ambition of the overall EU climate framework.
- The sink function of the LLULUCF sector should **not be used to displace mitigation efforts in the buildings, transport and agriculture sectors**.

Nine NGOs, including Carbon Market Watch, have recently published best practice principles for how best to deal with LULUCF in the EU's climate framework, see [here](#) .

## 6. Financial support to the power sector in low-income states

The 2030 council conclusions read:

**2.5 in this context, Member States with a GDP per capita below 60% of the EU average may opt to continue to give free allowances to the energy sector up to 2030. The maximum amount handed out for free after 2020 should be no more than 40% of the allowances allocated under 2.9 for auctioning to the Member States using this option. The current modalities, including transparency, should be improved to ensure that the funds are used to promote real investments modernising the energy sector, while avoiding distortions of the internal energy market;**

**2.7 a new reserve of 2% of the EU ETS allowances will be set aside to address particularly high additional investment needs in low income Member States (GDP per capita below 60% of the EU average). It will have the following characteristics:**

**- the proceeds from the reserve will be used to improve energy efficiency and to modernise the energy systems of these Member States, so as to provide their citizens with cleaner, secure and affordable energy;**

**- the use of the funds will be fully transparent;**  
**- allowances from the reserve will be auctioned according to the same principles and modalities as for other allowances;**  
**- the reserve will serve to establish a fund which will be managed by the beneficiary Member States, with the involvement of the EIB in the selection of projects. Simplified arrangements for small-scale projects will be ensured. Until 31 December 2030 the distribution of funds will be based on the combination of a 50% share of verified emissions and a 50% share of GDP criteria, but the basis on which projects are selected will be reviewed by the end of 2024;**

EU leaders agreed that Member States with a GDP per capita below 60% of the EU average qualify for certain compensatory measures under the EU ETS. These Member States include<sup>15</sup>: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia. While in the rest of the EU the power sector needs to buy their emission allowances from auctions, these low income Member States are allowed to continue handing out free allowances in return for modernizing their energy sector. Furthermore, EU leaders decided to establish a new reserve to address the investments needs of the energy systems of these low income Member States.

### Free allowances to power plants worth up to €11-€16.5 billion

From 2013 onwards, all power companies need to buy all of their emission allowances at auction. However, in the 2020 climate framework, ten new EU Member States were allowed to continue giving away free emission allowances to their power producers up to 2019. This provision was supposed to be temporary to avoid distortions of competition and on the condition that the value of these free allowances would instead be invested in diversification of these countries' energy mix. Eight Member States decided to make use of this mechanism and by the end of 2012, the European Commission had approved almost 680 million allowances to be handed out for free to power producers in these countries. Unfortunately it turned out that the majority of funds in some of the biggest beneficiaries of this provision (including Poland, Czech Republic and Romania) was not invested in solar or wind power generation but instead went into the modernization of existing fossil fuel generation capacity, which is in the case of Poland for example overwhelmingly dominated by coal.<sup>16</sup>

At the request of the low income countries, EU leaders have agreed to continue with this provision, although the current modalities need to improve to ensure that the funds promote real investments modernizing the energy sector.

Based on preliminary analysis, the amount of free allowances that could be given away by the nine Member States<sup>17</sup> to their power companies could reach around 550 million<sup>18</sup> in the period 2021-2030, with a monetary value of €11-€16.5 billion<sup>19</sup>. Poland will be the main beneficiary and is able to distribute around 250 million allowances to its power sector for free during 2021-2030 (with a monetary value of €5-€7,5 billion).

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<sup>15</sup> Based on Eurostat data (GDP in 2013 in EUR at market prices)

<sup>16</sup> Taken from: [Stronger Together](#): investment support and solidarity mechanisms under the EU's 2030 climate and energy framework (2014), a report by CAN-Europe, Greenpeace and WWF.

<sup>17</sup> Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Rumania and Slovakia

<sup>18</sup> Assuming the EU ETS cap for the 2021-2030 period equals 15.5 billion allowances (LRF of 2.2%) and assuming 44.5% of these will be given away for free (including heat allocations and the NER for new entrants), 400 million will be used for NER400 and 310 million used for the new reserve of modernization of the energy sector. The average auctioning volumes of the eight Member States are calculated without the redistribution mechanism, using the percentages indicated in a 2012 Oko-institut [report](#)

<sup>19</sup> Assuming a carbon price of between €20 and €30.

## Fund for modernization of power plants worth €6-€9 billion

EU leaders also decided to establish a fund in which 2% of the EU ETS allowances are set aside each year to address particularly high additional energy investment needs in the nine low income Member States. The proceeds will be used to improve energy efficiency and to modernize the energy systems of these Member States. The reserve will be managed by the beneficiary Member States, with the involvement of the European Investment Bank (EIB) in the selection of projects.

During the period 2021-2030, the reserve will consist of around 310 million allowances<sup>20</sup>, with an associated monetary value of around €6-€9 billion<sup>21</sup>. It will be up to the Member States in question to manage the reserve, with the involvement of the EIB.

It is of utmost importance that this new funding mechanism will not be used for the modernization of exiting coal power plants. The EIB's role in the project selection process should hence be binding to ensure that this money will benefit only energy efficiency and renewable projects.

## Next steps

We expect the European Commission next year to come forward with:

- An amendment to the EU ETS directive to **allow low income Member States** to continue giving **free allowances to their power sector** in return for investments in modernizing their energy sector.
- An amendment to the EU ETS directive to establish a **fund for the modernization of the energy systems** in low income Member States.

Both will be part of the EU ETS revision to implement the 2030 climate target.

## Carbon Market Watch Recommendations

- There should be modalities to ensure that the free allowances worth up to €16.5 billion do not serve to benefit European coal power plants, thereby significantly hampering the EU transition to an efficient and renewable power system. The Commission should therefore come forward with strict criteria to **ensure that the value of the free allowances are only used to support renewable energy and energy efficiency projects**.
- **The EIB should be given a bigger role** when selecting projects eligible for financing from the new modernization reserve, in order to make optimal use of the available money. The role of the EIB in the project selection process should be binding **to ensure that no money from the new reserve is used to support coal power plants**<sup>22</sup> but instead invested in projects that increase the share of renewable energy and energy efficiency.

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<sup>20</sup> Assuming an LRF of 2.2% from 2021 onwards.

<sup>21</sup> Assuming a carbon price of between €20 and €30 between 2021-2030.

<sup>22</sup> The EIB has recently strengthened its financing criteria which means that new and refurbished coal-fired power plants will be ineligible for funding unless they emit less than 550 g CO<sub>2</sub>/KWh.

## Conclusions

The conclusions reached by EU leaders on the 2030 climate and energy framework fall short of EU's fair contribution to tackling climate change. In order to keep global temperature rise below 2°C, the EU should adopt a climate target of at least 55% domestic emission reductions by 2030. Meaningful steps to increase EU's ambition ahead of the Paris climate summit are hence necessary to enhance the EU's leadership role in the international climate negotiations. This could incentivize other countries to step up their climate efforts too, leading to a race to the top and increasing our chances of avoiding dangerous climate change.

At the same time, the integrity of the EU's pledge to reduce domestic greenhouse gas emissions by 40% should be safeguarded. The below table includes details of some of the legislative initiatives that the Commission is expected to propose to implement the 2030 package, as well as recommendations how to strengthen these new proposals. The table does not give a complete overview, as also other legislation needs to be amended. But the EU ETS revision and the new legislation governing the non-ETS emissions set the overarching rules and ambition level on the basis of which these other policies need to be adapted.

Legislative Initiative	Council paragraph	Key recommendations
<b>Market Stability Reserve, in particular following proposed elements:</b>	2.3	
Start in 2021		Start as soon as possible (mid-2016)
Temporary removal of surplus allowances in case of large oversupply		Permanent removal of surplus allowances, so the 2030 target is not watered down to 24%-31% effective reductions
<b>Revision of the EU ETS directive, in particular expected proposals on:</b>		
Increase the Linear Reduction Factor (LRF) by which the cap on ETS emissions is reduced	2.3	Increase the LRF to at least 2.6% to make sure the EU ETS is in line with the linear pathway to the 2050 objective of reducing emissions by 80-95%
Decision on length of next trading period (phase 4)		Shorten the next trading period (phase 4) to 5 years (2021-2025)
Provisions to operationalize linking of emissions trading schemes		Inclusion of linking safeguards to ensure environmental integrity in case of linking EU ETS with other schemes
Provision on how to reduce auctioning volumes to operationalize the new flexibility option	2.12	Provision on how to reduce auctioning volumes to permanently cancel surplus allowances
Provisions how to address the risk of carbon leakage	2.4	Full auctioning of allowances combined with either: *border levelling to ensure imported products face similar carbon costs *targeted support for technologies that reduce emissions

Provisions to establish and operationalize a fund for low-carbon innovations	2.6	Establish a fund for renewable energy technologies and industrial low-carbon innovations
Enhanced modalities for allocation of free allowances to power sector (continuation of Article 10c)	2.5	Restrictions include binding provisions that investments benefit only renewable and energy efficiency projects
Provisions on establishment and operationalization of new modernization fund	2.7	Provisions to ensure the fund only supports energy efficiency and renewable energy projects; the EIB has a binding role in project selection process
<b>New legislation for non-ETS sectors, in particular expected proposals on:</b>		
Establishment of the annually binding country targets for the 2021-2030 period	2.10 + 2.11	Include a linear reduction factor in line with the 2050 climate objective
Provisions to define criteria for the use of EU ETS allowances	2.12	Define a conservative limit on the amount of EU ETS allowances
Define rules to establish and operationalize a domestic offsetting mechanism for the non-ETS sectors	2.12	Improved modalities for intra-EU transfers to unlock mitigation potential in low-income countries

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