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Subject:	Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments - Policy debate

1. At its meeting on 23-24 October 2014, the European Council agreed on the 2030 climate and energy policy framework for the European Union and endorsed a binding EU target of an at least 40% domestic reduction in greenhouse gas emissions by 2030 compared to 1990[1]. To achieve the target as cost-effectively as possible, the sectors covered by the EU ETS will need to reduce their emissions by 43% by 2030 compared to 2005, while the corresponding reduction in the non-ETS sectors will be 30%. The Commission is expected to present legislative proposals on the contribution of the non-ETS sectors by the end of July 2016.

[1] Doc. EUCO 169/14

2. In the context of the reform of the EU ETS, the Decision on the Market Stability Reserve [2], adopted in 2015, already made some important structural changes to the design of the system. On 15 July 2015, the Commission adopted a proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments[3], which constitutes a more comprehensive review of the ETS Directive [4] and aims to translate into legislation the guidance set out in the October 2014 European Council conclusions.

3. The European Parliament appointed Mr Ian Duncan (ECR) as Rapporteur on 16 September 2015. His draft report is scheduled to be voted on in the Committee on the Environment, Public Health and Food Safety (ENVI) on 8 December 2016. The Committee on Industry, Research and Energy (ITRE) has shared competence over certain parts of the proposal.

4. The European Economic and Social Committee and the Committee of the Regions adopted their opinions on 9 December 2015 and 7 April 2016, respectively.

5. Discussion on the Commission's proposal started within the Council during the Luxembourg Presidency. Ministers took part in a first policy debate on the proposal at the meeting of the Council (Environment) on 26 October 2015. Discussions have continued at technical level throughout the Netherlands Presidency.

6. On this basis, the Presidency has prepared a background note, which can be found in the Annex to this note, containing its assessment of the state of play and two questions to guide the policy debate which will be held at the meeting of the Council (Environment) on 20 June 2016.

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[2] Decision of the European Parliament and of the Council concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC, OJ L 264, 9.10.2015, p. 1.

[3] Doc. 11065/15 + ADD 1 + ADD 2 + ADD 3.

[4] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ L 275 , 25.10.2003, p. 32.

7. The <u>Committee of Permanent Representatives</u> is invited to take note of the background note and questions and to forward them to the Council.

8. To facilitate the organisation of the debate, delegations are requested to provide written replies to the Presidency and the Council Secretariat before the Council meeting.

ANNEX

PRESIDENCY BACKGROUND NOTE ON THE STATE OF PLAY ON THE REVISION OF THE EU ETS DIRECTIVE WITH QUESTIONS FOR MINISTERS

1. Introduction and general state of play

In the past six months, the Netherlands Presidency has focused the discussion in the Working Party on the Environment (WPE) on the ETS proposal on a number of key issues identified by the Presidency. In addition to the most politically sensitive issues, i.e. free allocation and measures against carbon leakage, and the proposed financial mechanisms (the modernisation and innovation funds, and the transitional free allocation to the energy sector), the WPE has addressed, *inter alia*, possible ways of further simplifying and reducing administrative burden in the EU ETS.

The Presidency recognises that a number of delegations have so far only been able to express general views and some delegations still have general or parliamentary scrutiny reservations on the proposal. However, the Presidency has the impression that good progress has been made in deepening the understanding of delegations of the Commission proposal and in exploring common ground among delegations. Various alternative approaches have also been discussed based on suggestions made by several individual delegations.

In general, the Presidency concludes that delegations broadly agree on the following:

- The revision of the ETS Directive should be in line with the guidance set out in the October 2014 European Council conclusions, the main objective of the ETS Directive, as well as the EU objectives under the 2030 climate and energy framework and the Paris Agreement.

- The EU ETS is an EU-wide system and should be as harmonised as possible and deliver emission reductions and incentivise innovation in the most cost-efficient way. At the same time it should take account of Member States’ specific circumstances to the extent possible, without jeopardizing the level playing field within the EU.

- Measures against carbon leakage must provide appropriate levels of support for sectors at risk of losing international competitiveness.

- The need to apply the cross-sectoral correction factor (CSCF) in phase 4 of the EU ETS should be kept to a minimum.

- The governance and use of the financial mechanisms should be transparent and clear, and support the objectives of the 2030 climate and energy framework. Administrative burden should be kept to a minimum.

- Possibilities to further simplify and reduce additional administrative burden in the EU ETS should be considered, especially for small installations, while preserving the environmental integrity of the Directive.

- It is necessary to fully ensure the role and appropriate involvement of the Member States in the decision-making process, including in the context of implementing legislation. The choice of instrument, i.e. implementing or delegated act, should be decided case by case in the context of the discussion on the substantive elements of the relevant provisions of the proposal.

In the following sections, the Presidency provides its assessment of the views expressed so far by delegations on specific key issues of the proposal, followed by two questions for the Ministers to guide the debate at the Council.

2. Linear reduction percentage

Delegations support the increase of the linear reduction factor (LRF) to 2.2 % as of 2021, as set out in paragraph 2.3 of the European Council Conclusions. A number of delegations have pointed out that the LRF may need to be reviewed in the light of the EU contribution to the COP21 goal of keeping the temperature rise well below 2 degrees and to pursue efforts to limit the temperature increase to 1.5 °C above pre-industrial levels. Other delegations have stressed the importance of sufficient foresight about the level of the LRF for predictability of the ETS.

3. Free allocation and carbon leakage provisions

The October 2014 European Council Conclusions provided for a continuation of free allocation and set out guiding principles for the allocation of free allowances during phase 4 of the EU ETS. The guidance covered several interlinked aspects:

1. The share (of the overall amount of allowances) to be auctioned/allocated for free in phase 4 of the EU ETS

2. The periodical review of benchmarks for free allocations in line with technological progress

3. Carbon leakage criteria

4. Indirect carbon costs

5. Better alignment with changing production levels in different sectors

Due to the linkages between most of the above aspects, any adjustments to a single element would need to be appropriately taken into account and, if necessary, reflected in the overall design.

Efforts to bring further dynamism and focus in the system should not add unnecessary complexity and administrative burden to it. Moreover, the extent to which the CSCF will need to be applied during phase 4 will be determined by the interplay of *inter alia* the benchmark updates, carbon leakage criteria, and adjustments in allocation to follow significant changes in production levels.

3.1 The fixed share for auction and free allocation

According to the Commission's proposal, the share of allowances to be auctioned and to be allocated free of charge in phase 4 should be fixed at 57% and 43%, respectively. Delegations support determining the auction share in the revised Directive in accordance with the October 2014 European Council conclusions as a way to ensure predictability. Many delegations have indicated support for the split as proposed by the Commission. A few delegations suggest alternative options to calculate the auctioning share for the 2021-2030 period, which would
increase the share of free allowances, arguing that this would further decrease the likelihood of having to apply the CSCF.

As the issue is difficult to discuss in isolation from the other interconnected aspects, as mentioned above, the Presidency suggests postponing possible further discussion on it until there is more clarity on the other aspects.

3.2 Benchmarks

The European Council agreed for the benchmarks to be periodically reviewed to ensure they are in line with technological progress in the respective industry sectors. Updating of the benchmark values for phase 4 free allocations is an important aspect of the future carbon leakage regime. Discussions have so far focused on how to strike the balance between realistic benchmarks on the one hand, and predictability and continued incentives for innovation on the other hand, keeping in mind also the need to limit administrative burden. If ongoing technological progress is reflected in the benchmark values in a timely manner throughout phase 4, the need for a correction factor to be applied in phase 4 will be lower.

Many delegations support updating benchmark values twice for phase 4 (2021 and 2026), with several delegations preferring all benchmarks to be recalculated before the start of phase 4 and to be based on recent verified data (e.g. 2017-2018 for 2021 and 2022-2023 for 2026). The improvement rate could be, for example, a separate flat rate for the five year period or an annual flat rate reduction for the five year period based on historic reduction. However, several delegations have expressed concerns that the flat rate percentage reduction in benchmark values may not accurately reflect technological progress. Further work is needed on how to strike the right balance between realistic (what has been achieved by industry) and
ambitious benchmarks. In this balance, attention should be paid also to the need to limit administrative burden.

The Presidency suggests that further deliberations focus on the following aspects:

- the pros and cons of recalculation of the benchmarks before the start of phase 4
- the use of standard values for the benchmark updates
- how to take into account process emissions and other sectoral specificities
- the use of a flat improvement rate for the five year period or of an annual flat rate reduction for the five year period based on historic reduction
- the treatment of the fallback benchmarks.

3.3 Carbon leakage

In principle, delegations agree that carbon leakage protection for industry should be better targeted based on the degree of carbon leakage risk so that those sectors and sub-sectors deemed at most risk receive the highest share of free allocation. There is broad support for the proposed criteria (trade intensity and emission intensity) for classifying the carbon leakage groups. Some delegations have proposed, as an alternative to the two-tier approach proposed by the Commission, a more differentiated system with more than the two tiers, arguing that it would provide more focused protection against carbon leakage and could lower the likelihood of triggering a correction factor in phase 4. A few delegations suggest that free allocation to less-exposed industrial sectors should be phased out. Some delegations have suggested introducing additional criteria, such as a geographical criterion or a criterion based on the ability to pass through carbon costs, or alternative approaches such a carbon inclusion mechanism for imports.

Several delegations question the political and technical feasibility of a carbon inclusion mechanism and also wonder whether the system would comply with WTO criteria. Some delegations have argued that they could only support an approach with three or more tiers if this also contained a geographical criterion (e.g. a sector and Member State specific trade intensity criterion).

The Presidency suggests that further deliberations focus on the following aspects:

- the pros and cons of a two-tier system, as proposed by the Commission, vis-à-vis a system with more tiers
- the design of the tiers, among others the allocation rate per tier.

3.4 Significant changes in production levels

Better alignment of phase 4 free allocations with recent verified production data is an important aspect of the future carbon leakage regime. In general, delegations agree that the system should be more dynamic, while avoiding excessive administrative burden. Several delegations support the use of two 5-year phases for allocation and synchronising the cycle with that of the benchmark updates. Many delegations consider that within a 5-year allocation cycle, allocations should be adjusted for significant production increases and decreases via the phase 4 new entrant reserve in a symmetric manner and that the thresholds should be substantially lower than the current 50% threshold, i.e. in the 10%-15% range, and would prefer to have the threshold spelled out in the Directive. Other delegations have indicated that as an alternative to spelling out thresholds in the Directive, specific guidance could be provided for setting the thresholds in implementing rules.

The Presidency suggests following up on the approach preferred by many delegations to set out the threshold in the Directive. It is important in further discussions to determine the administrative burden resulting from different threshold levels and explore what kind of mitigating measures could be put in place (e.g. a rolling mean value or a time lag of one or two years).

3.5 Compensation for indirect carbon costs

The compensation for indirect carbon costs for power-intensive industry is an important aspect of the future carbon leakage regime. All delegations recognise the need for a transparent system and many delegations call for more harmonisation, among others referring to recital 9 of Decision 2015/1814, which states that the review of Directive 2003/87/EC should also consider harmonised arrangements to compensate for indirect costs at Union level. However, most of the delegations are opposed to a mandatory system. Different options have been discussed ranging from a continuation of the current system, further harmonisation (with opt-out possibilities) to full harmonisation (compensation from a centralised European fund).

Some delegations agree with the Commission proposal while others are interested in exploring alternative approaches. The issue is complex and requires further discussion. As a way forward, the Presidency suggests taking the Commission's proposal as a starting point and exploring whether some additional elements of a compensation scheme could be further harmonised and whether such elements could be included in the Directive with respect to criteria for indirect cost compensation.

4. The funds and transitional free allocation to the energy sector

4.1 Modernisation Fund

The Modernisation Fund represents an important tool to support the modernisation of the energy sector in low income Member States. Projects should contribute to achieving the 2030 climate and energy objectives. Delegations agree on including this as a criterion in the Directive. Delegations agree that the transparency of the selection process and the monitoring and reporting of results of projects must be guaranteed, as well as an efficient governance structure, as foreseen by the European Council in its conclusions of October 2014. However, the views of Member States eligible for support from the fund and other Member States differ on its governance and management, in particular regarding the number of governing bodies and the respective roles of eligible and other Member States, the Commission and the European Investment Bank (EIB).

Transparency can be ensured through robust monitoring and reporting rules. Many delegations agree that the governance and transparency provisions should be set out in the Directive itself. In the discussion, linkages have been made between the level of detail regarding scope and transparency on the one hand, and the governance arrangements on the other hand. Eligible Member States do not think it is necessary to specify in detail specific types of projects or selection criteria. Some other delegations would prefer to include some more specification as to the types of projects supported, focusing in particular on those promoting renewables, energy efficiency and grid investments.

Further work is needed on finding the right balance between the rules *inter alia* on scope, governance, and procedures enabling the fund to function as intended, as well as to determine which elements should be set in the Directive and which ones can be defined later. One of the topics to explore further is whether further details on the scope are necessary to ensure that investments through the fund contribute to the objectives of the 2030 climate and energy framework and the Paris Agreement. In addition, a clear and precise definition of the scope as well as the transparency and reporting provisions of the fund could help to counterbalance more flexibility in the governance arrangements.

4.2 Transitional free allowances for the modernisation of the energy sector

Within the quantitative limits defined by the European Council in its conclusions of October 2014, low income Member States have the option to provide transitional free allowances to power generators in exchange for investments in the modernization of the energy sector (Article 10c). Delegations generally agree that the transparency of the selection process, and the monitoring and reporting of results and effects of undertaken investments of projects must be ensured and be part of future Article 10c arrangements. Some delegations suggest seeking synergies between the use of Article 10c and the Modernisation Fund in order to increase efficiency, reduce administrative burden and avoid overlap.

Competitive bidding is proposed in order to enhance transparency and avoid distortions of competition in the use of this derogation. Delegations have different opinions on the threshold for projects that are subject to the competitive bidding procedure. The Presidency concludes that further work is needed on the scope of competitive bidding (e.g. on the thresholds for projects subject to competitive bidding). Other topics to explore further are whether further details on the scope are necessary to ensure that investments contribute to the objectives of the 2030 climate and energy framework and the Paris Agreement, and how to seek synergies between the use of Article 10c and the Modernisation Fund in order to increase efficiency and avoid overlap.

4.3 Innovation Fund

In general terms, delegations support the proposed scope and size of the Innovation Fund and emphasise the strategic importance of enabling access for energy intensive industry to support low carbon innovation through the fund. The selection of projects/the allocation of funds should be primarily based on merit, while access to bid on fair terms should be enabled to allow for a wide and balanced geographical spread of projects. Most delegations are in favour of simplified procedures for smaller projects, also to enable a wide geographical spread of projects. A number of delegations ask for explicit mentioning that funding possibilities will be available also for Carbon Capture and Utilisation projects (CCU).

The Presidency proposes to further explore the need for a wide geographical spread if simplified procedures and access to bid on fair terms are in place. The Presidency invites industry to come forward with concrete ideas regarding the use of the Innovation Fund.

5. Simplification of the EU ETS and opt-out

Delegations agree on the need for simple arrangements to avoid undue administrative costs in the implementation of the revised EU ETS, for both regulated installations and public authorities. Simplification should be properly balanced with environmental integrity and a high level of registry security. Delegations agree that this aspiration should be included in the Directive. Scope for further simplification should be explored *inter alia* in the context of monitoring, reporting and verification (MRV), as well as on registry aspects.

Further discussion is needed on the possible scope and conditions governing the opt-out of smaller emitters in phase 4, on how to reflect the wish and need for further simplification in the Directive (either in recitals or in the operative part), and on which changes in the Directive are needed to enable the implementation of certain options.

The Presidency suggests taking into account the planned work in the MRV and registry expert meetings later this year and the feedback from these meetings regarding proposals for simplification made in the Working Party.

6. Delegated and implementing acts

A number of delegated and implementing acts are proposed in the Commission's proposal. The main objective is a workable ETS. In general terms, delegations agree that the key and most political elements should be determined in the Directive itself. The revised ETS should be fit for purpose until 2030; not everything can be regulated in the basic act itself. Therefore, there is a balance to be struck. A number of delegations consider that the Climate Change Committee should maintain a role in the process. Delegations agree that the powers entrusted to the Commission should be clearly defined.

The Presidency suggests discussing the proposed implementing and delegated acts on a case by case basis once there is more clarity on the relevant key provisions of the proposal, among others the benchmark updates, rules for free allocation, and the funds.

7. Other issues

According to the October 2014 European Council conclusions, a well-functioning, reformed EU ETS will be the main European instrument to achieve the 2030 greenhouse gas target. Some delegations have expressed concerns that with the prevailing weak carbon price signal the EU ETS is currently not playing this envisaged role. The importance of the future implementation of the Market Stability Reserve and the preservation of its integrity has been underlined in this regard, but some delegations have expressed the view that further measures should be discussed to ensure a well-functioning EU ETS. One delegation has proposed to consider the introduction of direct price regulation via a soft price collar.

The Presidency suggests exploring options consistent with and complementary to the MSR.

One delegation suggested creating and accepting credits for additionally removed carbon dioxide in the forestry sector for compliance in the EU ETS. Many delegations expressed strong reservations about this proposal and emphasised that forestry aspects should be further discussed in the context of the forthcoming Commission proposal on non-ETS targets.

8. Review

Based on the suggestion from several delegations, the Presidency suggests introducing a review clause in the Directive, referring to the Paris Agreement and to the need, as demonstrated by the various adjustments that have been required during phase 3, to ensure that the EU ETS remains robust and adaptive. Several design variables such as benchmarks and production levels are already proposed to be updated during phase 4. To enable adapting to potentially changing circumstances as a result of the provisions in the Paris Agreement, it is suggested that the provisions on a future review of the EU ETS should have a clear focus on the following questions:

- Is the EU ETS linear reduction factor still in line with the EU's climate goals?
- Are the carbon leakage criteria still in line with the international developments, in view of the Paris Agreement and developments with regard to implementation of carbon markets in other major economies?

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Questions for Ministers:

Against this background and to seek political guidance on the way forward, the Presidency invites the Council (Environment) to address the following questions:

1. Do you agree on the proposed way forward as suggested by the Presidency on the main policy choices to be made?

2. Do the proposed revisions make the EU ETS future-proof, with regard to the global climate objectives formulated in the Paris Agreement?