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MEETING DOCUMENT

From:	General Secretariat of the Council
To:	Working Party on the Environment
Subject:	Non-ETS (ESR): WPE 2 March - BE non-paper on the one-off flexibility

With a view to the WPE meeting on 2 March delegations will find attached a non-paper from Belgium on the above.

BE non-paper on the one-off flexibility

Introduction

In October 2014, the European Council called for a limited, one off reduction of the ETS allowances, to be decided before 2020, while preserving predictability and environmental integrity. In line with these guidelines, the Commission's Effort Sharing Regulation (ESR) proposal provides for a limited flexibility between the ETS and the ESR (100 million allowances), to be distributed among those member states whose target is both significantly above their cost effective potential and the average EU target.

Belgium supports the overall architecture of the one-off flexibility as proposed by the Commission, both with respect to the overall limit (100 million) as the distribution among member states. However, we find it problematic that member states are forced to make a final decision on the use of this mechanism before 2020. As this non-paper will explain in more detail, there are many uncertainties regarding the need for this flexibility before 2020. Confronted with these uncertainties, risk-averse member states will be inclined to make full use of this mechanism, with potential negative consequences for the eligible member states, member states which are net-sellers of AEAs, and the overall cost-effectiveness and environmental integrity of the European climate framework.

Belgium therefore argues for a system that allows member states to revise their initial decision downwards during the period 2021-2030, with a 2-year notification period. The limited volume and the 2-year notification period will limit any possible impact on the ETS market.

Uncertainties on the need for flexibility between ETS and the ESR

The Commission's proposal requires member states to make a final decision on the use of this mechanism by 31 December 2019 at the latest. However, at that point in time, it is nearly impossible for a member state to assess the need for such a flexibility due to several uncertainties:

- The **AEA budgets for 2021-2030** will only be determined in 2020, after the deadline for the one-off decision. Prior to 2020, there are still uncertainties with regard to the emissions for 2018 (inventory not yet available), for 2016-2017 (susceptible to inventory corrections) and for 2005 (susceptible to inventory corrections + uncertainty regarding the scope correction for installations that were included in the ETS after 2005);
- There is a high degree of **uncertainty about the projected emission levels in the period 2021-2030**. This can be attributed to uncertainty about the impact of climate policies, and the impact of exogenous factors such as economic conjuncture, energy prices, technological developments and weather variations.
- Finally, by 2019 it will still be highly uncertain to what extent **flexibilities between member states within the ESR** will be functioning properly, i.e. how many AEA's will be available for transfers between member states and at what price.

Uncertainty will lead to maximum use of ETS flexibility

Those member states which have access to the ETS flexibility face a significant challenge to respect their greenhouse gas budgets in the period 2021-2030. Even under the most ambitious EUCO30 scenario, these member states are facing a collective reduction gap of more than 100 Mt. It is thus clear that these member states will have to rely – at least partially - on flexibilities to ensure compliance.

If member states have to make a final decision on the use of this flexibility before 2020, they will be inclined to use its full potential, given the extent of the challenge and the uncertainties described above. This in its turn can have several negative consequences for both the member states involved as the EU as a whole:

Reduced transfers between member states under the ESR

Belgium believes transfers between member states under the ESR should be preferred over the flexibilities between the ESR and the ETS. Such transfers allow all member states to be in compliance with the ESR without increasing the emission budget under the system. Furthermore, transfers can trigger reductions in lower-income member states, for which the differentiated targets under the ESR provide little incentive, although they still have a low-cost potential to grasp. The flexibility with the ETS should therefore be used only as a safety valve, in case there is insufficient liquidity of AEA's in the period 2021-2030.

However, even if it becomes clear in the course of 2021-2030 that intra-ESR flexibilities are well-functioning, member states which have chosen to use the ETS flexibility are no longer able to reconsider their decision and use intra-ESR flexibilities instead. Consequently, the demand for AEA's and the volume of transfers between member states will decrease.

Increased overall emission budget for the period 2021-2030

In October 2014, it was deemed that the one-off flexibility did not impact the overall ambition level of the climate framework for 2021-2030. However, with the introduction of the MSR, the regulating context has changed. The use of the one-off flexibility mechanism indirectly leads to less absorption by the MSR, and thus an increased emission budget on the market for the period 2021-2030. This is an additional argument to allow member states to reconsider their initial decision to use the ETS flexibilities, and use AEA's of other member states instead if these become available in 2021-2030.

Reduced incentive to take additional measures in the ESR

Obviously, the more the flexibility with the ETS is used, the bigger the emission budget under the ESR and the lower the incentive to reduce in these sectors:

- as demand for AEA's decreases, potential selling member states have less incentives to make additional reductions and sell the corresponding AEA's ;
- The incentive is also reduced for those member states which are using the ETS flexibility. In the scenario that additional measures become available in the course of the period 2021-2030 – e.g. due to technological breakthroughs or a changed political context – the obligation to continue using the ETS flexibility undermines the chances for such measures to be implemented.

Decreased cost-effectiveness for achieving the EU wide targets

In addition, the overall cost-effectiveness for achieving the EU wide -40% reduction target is weakened. By imposing a final decision on the use of ETS flexibility before 2020, member states no longer have the choice to switch to intra-ESR flexibilities even if these would prove to be more cost-effective in the course of 2021-2030. As a result, more cost-effective reductions in the ESR remain untapped while the eligible member states are forced to use the less cost-effective ETS flexibility.

Ensuring stability on the ETS market

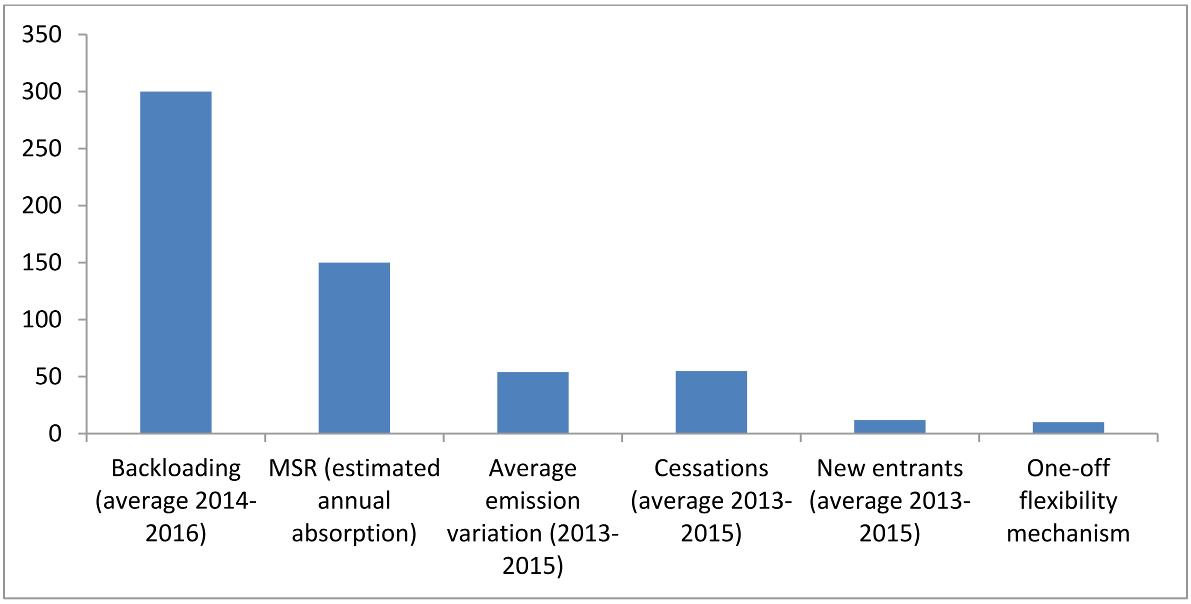
The only argument for requiring a pre-2020 decision, is the need to ensure predictability for the ETS market. For a highly industrialized country such as Belgium, a stable and predictable ETS market is certainly an important priority. However, we do not believe that the ETS flexibility poses any threat to market stability, given the overall limited volume of the mechanism. In addition, the mechanism could be designed in a way that further reduces any impact on the ETS:

Overall limited volume of the mechanism

The overall volume of the mechanism is limited at 100 million for the entire period 2021-2030. Given that the allowances will be cancelled equally over the years (1/10th each year), this means the overall impact is limited at maximum 10 million allowances per year, which is on average about 0,65% of the overall EU ETS cap.

In comparison, there are several other uncertainties for the stability of the EU ETS market – among which some are induced by mechanisms which the Commission has proposed and member states have approved. These uncertainties have a far larger potential impact (in terms of volume) than the one-off flexibility mechanism:

Figure 1: Instruments and fluctuations inducing a level of uncertainty on the ETS market and their volume (in annual Mt $CO_{2eq.}$)



- In the period 2014-2016, on average 300 million allowances were withheld from the market on an annual basis, with a very limited impact on the ETS market;
- According to own calculations, the MSR is expected to absorb between 100 and 200 million allowances each year between 2020 and 2025, depending on emission trends in those years. These figures are in line with the estimates by the EEA[1]. It should be noted that the range of possible absorption (between 100 million and 200 million per year) is more than the tenfold of the total volume of the ETS flexibility mechanism with the ESR (10 million per year);
- Between 2013 and 2014, ETS emissions decreased by 95 Mt $CO_{2eq.}$. Between 2014 and 2015, the decrease was only about 13 Mt. This illustrates that emissions can vary significantly on a year to year basis and with a magnitude that is much higher than the one-off ETS flexibility;
- Between 2013 and 2015, 165 million allowances remained unallocated due to cessations, which translates in an average annual volume of 55 million. On the other hand, about 35 million allowances were put into circulation from the NER in the same period (which translates in an average annual volume of 11,5 million);
- Compared to the elements above, the volume of the ETS flexibility is very limited as it could only reach 10 million allowances per year in the most extensive case.

Proposal:

Fix the maximum amount pre-2020, and allow for a downwards adjustment only

In addition, it can be arranged that the maximum amount of ETS flexibility per member state is fixed in 2020, as currently provided for in article 4(4) in the Commission's proposal. After that, member states can only revise their amount downwards. This would have as an advantage that the *pro rata* reduction as foreseen in art. 4(4) would only have to be calculated once. A second advantage is that the market has certainty on the maximum use of the ETS flexibility.

Require a two-year notification for revising the decision

In order to further limit any impact of the mechanism on the ETS market, it could be provided that member states are required to notify any revision on the use of the mechanism at least two years in advance. This builds on the current timetable as foreseen by the Commission:

Table 2: timetable for decisions

	Deadline for decision	Impact of decision
Original decision	31/12/2019	As of 2021
Possible revision	31/12/2020	As of 2022
Possible revision	…	…

If other member states still feel that the predictability for the ETS market is insufficiently guaranteed, it could be even considered to allow for only one revision halfway the period (decision before 2025, implementation as of 2026). Although Belgium does not believe an annual revision poses any threat, such a one-time opportunity for revision would still be a significant improvement compared to the Commission's proposal.

[1] EEA (2016), *Trends and projections in the EU ETS in 2016,* EEA report No 24/2016