



Council of the  
European Union

Brussels, 15 June 2016  
(OR. en)

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**Interinstitutional File:**  
2015/0148 (COD)

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10237/16  
ADD 1

CLIMA 74  
ENV 426  
ENER 254  
TRANS 242  
IND 140  
COMPET 377  
MI 452  
ECOFIN 610  
CODEC 884

**NOTE**

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From: General Secretariat of the Council  
To: Delegations

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No. prev. doc.: 9719/16 CLIMA 59 ENV 380 ENER 231 TRANS 210 IND 125 COMPET  
349 MI 408 ECOFIN 534 CODEC 802

No. Cion doc.: 11065/15 CLIMA 88 ENV 499 ENER 289 TRANS 241 IND 116 COMPET  
370 MI 498 ECPFOM 621 CODEC 1059 - COM(2015) 337 FINAL

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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  
= *Delegations' contributions*

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With a view to the Council (Environment) on 20 June 2016, delegations will find in the Annex  
non -papers from Hungary and Poland.

HUNGARY**A few points suggested for consideration as regards free allocation, carbon leakage list and compensation of indirect costs of the EU ETS****1. Determining the free allocation for incumbent installations in practice***1.1 The process according to the Proposal*

According to the proposal<sup>1</sup> of the European Commission (hereinafter referred to as Commission), as we understand it, the determination of the free allocation for incumbent installations is carried out through the following process.

As a first step, a list of 'information on production activity, transfers of heat and gases, electricity production and emissions at sub-installation level over the five calendar years preceding its submission' shall be submitted before 30 September 2018<sup>2</sup> - with the terminology of the 3<sup>rd</sup> period, a National Implementing Measures (NIMs) List. Based on these data, the determination of which sector will belong to which flat-rate<sup>3</sup> concerning the benchmark update will be carried out by the Commission. Meanwhile, the carbon leakage list will be prepared and adopted by the Commission before 31 December 2019<sup>4</sup>.

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<sup>1</sup> 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; COM(2015) 337 final, hereinafter referred as the 'proposal'.

<sup>2</sup> Article 1 (8) of the proposal: - the new second subparagraph of Article 11(1).

<sup>3</sup> Article 1(5), point (b) of the proposal – the new third sub-paragraph of Article 10a(2).

<sup>4</sup> Article 1(6) of the proposal – point 4 of the new text of Article 10b.

The difficulty at this point is that the new carbon leakage list might change the sub-installation boundaries in the case of the fall-back benchmark sub-installations. The new list will be completely different from the previous one, based on new criteria – a much shorter list. Therefore, if we take into consideration the heat export-import rules, the number of installations where the sub-installation borders change might be high. For these installations, the above -mentioned verified data has to be submitted once more. The benchmark values will have to be updated as well, and the new carbon leakage list might also change the preliminary allocation values, but in cases where there are no changes of sub-installation borders, these modifications can be done by the Competent Authorities (hereinafter referred to as CA). As a result of the new benchmarks and the carbon leakage list, the whole NIMs List has to be submitted to the Commission once more, with an undefined deadline, most likely in the first half of 2020.

The Commission then determines the cross-sectoral correction factor (CSCF) for the first five-year period. If the value of CSCF is not zero, CA will have to determine the final allocations for each sub-installation by amending the NIMs List to include the new CSCF value, and submit it for the third time to the Commission. If all deadlines are met, this will be ready before the end of 2020. A short time after the process is finished, it will start again from the beginning with the determination of the allocation for the second five-year period (except for the carbon leakage list determination). The three-step method, as described above, is very complex and there is significant room for simplifications. Step two in particular seems to be avoidable if another approach is taken.

## *1.2 HU suggestions*

Concerning the revision of the benchmarks, we prefer to use real data instead of the flat-rate approach of the proposal - the reasons and a possible alternative to decrease the administrative burden will be explained below. Furthermore, we would prefer the carbon leakage list to be determined with an earlier deadline; this would raise the predictability of the system and propel investments in the industry.

With these two modifications, the free allocation would be determined as follows.

Once the amended Directive<sup>5</sup> is adopted, the Commission starts to collect the data for the benchmark revision and the carbon leakage list immediately. The methodology can be the same as in the 3<sup>rd</sup> period. We estimate that it might be possible to adopt the delegated acts prescribing the new benchmark values and carbon leakage list by 31 December 2018 – the exact, realistic date has to be determined by the Commission experts. The NIMs List with the sub-installation level information must be submitted after the delegated acts on the new benchmark values and carbon leakage are adopted, possibly with a deadline in mid-2019 in order to avoid the parallel submission with the emission reports from 2018. This way it would be possible to use the base period of 2014-2018 instead of 2013-2017, which would, by reducing the delay in time, better align the allocation to the production data. The Commission will then determine the CSCF value. If the value of CSCF is not zero, CA will add it to the NIMs Lists and re-submit it to the Commission. The process will be completed before the end of 2020.

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<sup>5</sup> In this document, the term 'Directive' refers to Directive 2003/87/EC of the European Parliament and of the Council. The proposal aims to amend that Directive.

## 2. Elements of the free allocation

### *2.1 Revision of benchmarks*

Concerning the updating of the benchmarks, we would like to ask the Commission to gather the exact data from the installations and apply the calculation method based on them instead of using the proposed flat-rate approach, at least at the beginning of the 4<sup>th</sup> trading period. We think that the flat-rate approach increases the risk of determining unrealistic benchmarks for some sectors which cannot be achieved in real life; therefore the installations concerned can face severe shortage in free allocation. This is true especially for sectors with high process emissions. In some other cases, where the level of technological improvement was high, over-allocation can happen when taking the flat-rate approach.

Taking into consideration the advantages of the flat-rate approach based on the Commission's communication, it was shown under point 1.1 of this document that the administrative burden is also rather high with the solution contained in the proposal. Furthermore, the predictability is low as single installations will not know which benchmark reduction value will apply to them in the two five-year periods. Incentives to innovate will be reduced by any kind of benchmark update method; however, we do not think that the difference in this aspect is significant between the two approaches. We organised a consultation amongst the Hungarian ETS installations, and many responses showed the determination of the industry to shoulder the higher administrative burden of going through the data collection process as a trade-off to get more realistic benchmarks.

## 2.2 Cross-sectoral correction factor (CSCF)

For the modelling of the CSCF value in the years beyond 2020, the greatest uncertainty is the activity (production) level of the EU ETS installations in the base years of the 4<sup>th</sup> trading period. The maximum number of allowances for allocation is declining in a pre-determined, linear way but the allocation does not follow this pattern: it will have different characteristics every time a new NIMs is determined. In the first five-year period, the historical activity level<sup>6</sup> (HAL) is still affected by the economic crisis, therefore the sum of the HALs of all installations might be lower than it was in the 3<sup>rd</sup> trading period (or at least not much higher), meaning that the CSCF can be either zero or a quite modest figure. As the production levels rise, this might not be true for the second five-year period. The higher the economic performance (HAL) is, the higher a CSCF is needed. We welcome the suggestion in the proposal to use the remaining allowances from the early years of the 4<sup>th</sup> period to lower the CSCF value in its late years.<sup>7</sup> As the cap is getting smaller every year, in the case of an optimistic economic scenario, the measures in the proposal will not guarantee the elimination of the CSCF. With a value dependent on the HAL levels, the CSCF might remain a part of the system in the 4<sup>th</sup> trading period. We believe that such a factor imposes undue costs on the best performers; therefore, it is against the European Council Conclusions of 23-24<sup>th</sup> of October 2014. Still, the limit of the free allocation has to be kept. We are committed to determining the free allocation rules for the 4<sup>th</sup> trading period in a way that eliminates the need for a CSCF or at least minimises its value.

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<sup>6</sup> Determined as the median production of the five base years of the sub-installation.

<sup>7</sup> Article 1(5), point ( c) of the proposal – of the new text of the first sub-paragraph of paragraph 6 of Article 10a.

### 2.3 Aligning production and allocation

The proposal introduces the concept of significant production increase<sup>8</sup> in the system. Since the principle of symmetry with partial cessation is used in this provision, as we understand, with the current rules installations would have to exceed 150% of their HAL level to be eligible for the extra allowances. Although for the period of 2021-2025 the HAL levels (which are, according to the proposal, based on 2013-2017 production levels) might be quite low as they are influenced by the economic crisis and the capacity utilisation is low in many cases, most of the installations might not be able to exceed this threshold and use this provision without physically extending the capacity (when they are eligible to request allowances from the new entrant reserve anyway). Considering this, the new provision might not be of much help, although it is possible that a rather high number of installations might produce at activity levels of between 100% and 150% of their HAL value; thus, shortage of allowances might be a common phenomenon. Therefore, it is suggested to introduce a new threshold for the partial cessation and production increases. This will also help to avoid the windfall profits resulting from producing between the levels of 50% and 100%, which happened in many cases in the 3<sup>rd</sup> period.

Concerning the exact threshold value, it has to be determined as an optimum between the need for extra allowances and keeping the administrative burden low. If its value is too close to 100%, every year a very high number of installations might report changes in the allocation. Such a situation would be very hard to handle with the current NIMs sheet – NER sheet procedure.

If such a close alignment were to be the preferred option, we would suggest giving consideration to full dynamic allocation<sup>9</sup> with the development of a much simpler administrative process for allocation changes.

If the system is not operating with a full dynamic allocation, a solution could be to introduce a new threshold-pair, while maintaining the existing ones as well. For example, these can be 75% and 125% - cutting the allocation to 75% when production is between 50% and 75% of the HAL, and allowing a request for an extra 25% of the original allocation once production exceeds 125% of the HAL.

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<sup>8</sup> Article 1(5), point (a) of the Proposal – of the new text of the second sub-paragraph of paragraph 1 of Article 10a.

<sup>9</sup> The term dynamic allocation is used for a theoretical system where the allocation is determined on a year-by-year basis for all installations with some kind of ex ante or ex post methodology, taking into account the most recent production data.

We are not against the suggestion of several Member States to determine the thresholds in the Directive instead of using a delegated act as provided for in the proposal.

#### *2.4 Amendments to the carbon leakage list*

Our concern is that a carbon leakage list fixed for ten years (plus the time lag between the base year of the data on which the carbon leakage list was determined and 2021) will not be able to keep up with the rapid changes on the world market. Therefore, it would be better to have the possibility to supplement the list during its ten-year life span if the circumstances of a sector change dramatically. On the other hand, this cannot result in a higher CSCF value, and the administrative burden on the CAs and the Commission due to allocation modifications has to be limited as well. The perfect solution has not been found yet; nevertheless, we would like to raise this point and start a debate about the topic.

#### *2.5 Sectors not on the carbon leakage list*

The allocation for sectors which are not on the carbon leakage list should not decline to zero by 2027. Instead, these sectors should be dealt with in accordance with the proposal: with a constant 30% allocation level. This principle is especially important in the district heating sector,<sup>10</sup> which competes not with international competitors but with the possibility that the consumers switch to their own independent heating systems, causing emissions to ‘leak’ from the ETS. Therefore, it is important to provide a heating service to consumers (especially in the residual sector) at an affordable price.

### **3. Further possibilities of raising predictability and legal certainty**

#### *3.1 Carbon leakage list in 2020*

The current carbon leakage (CL) list will expire on 31 December 2019. It is our understanding that the new list to be designed with the rules of the 4<sup>th</sup> trading period will be in effect from 2021 (although, if our suggestions in point 1.2 are accepted, it might be adopted and published well before this date). There seems to be a gap in 2020 between the two lists. It would not be wise to use the 4<sup>th</sup> period CL list in 2020, because, as we pointed out under point 1.1, it will result in a number of changes in sub-installation borders and allocations. Going through the administrative process of these changes for the sake of only one year, especially in a period when the Commission and CAs are busy with the 4<sup>th</sup> period NIMs, is not proportionate.

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<sup>10</sup> Article 10a(4) of the current Directive.



It is also not worth asking the Commission to determine a CL list for one year, which would also result in a (limited) number of changes. The limited resources are needed for the preparation of the 4<sup>th</sup> period. Therefore, we suggest the adoption of the necessary legal changes as soon as possible in order to extend the validity of the current list (until the end of 2020) and thereby provide the necessary legal certainty and predictability for the industrial stakeholders.

### *3.2 Definition of new entrants*

The definition for new entrants in the Directive uses the term ‘after 30 June 2011’<sup>11</sup> to separate the incumbent installations from the new entrants (and significant capacity extensions). The proposal does not update this date.

The logic behind the proposal could have been that this will be updated later in the delegated act (any possible date determined in the delegated act will be ‘after 30 June 2011’). We think that from the point of legal certainty, predictability and transparency of the EU ETS, it is better if the update is done in the text of the Directive. Considering what would happen if for any legal reasons the old date has to be used, concerns are raised regarding the amount of allowances in the new entrant reserve (as all new entrants and capacity extensions from the 3<sup>rd</sup> period would require allocation from the reserve as well) and the administrative burden (as installations with capacity extensions during the 3<sup>rd</sup> period would have to submit a NIMs sheet for the incumbent part of the installation and a New Entrant Request for the extended part). It has to be ensured that new entrants and capacity extensions are allowed to become incumbent installations when the next NIMs List is submitted. Therefore, we suggest amending the date of 30 June 2011 in the Directive; the new date might be the date preceding the submission of the actual NIMs list by 3 months.

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<sup>11</sup> Article 3, point (h) of the current Directive.

#### **4. Indirect carbon costs passed on through electricity prices – a proper compensation scheme for sectors exposed to the risk of carbon leakage**

##### *4.1 Our concerns*

We noted the arguments concerning the problems arising from the different ways in which this matter is handled in the Member States. Currently some Member States give compensation, but with differences in the detailed rules and amounts allocated for this purpose, while most Member States, like Hungary, do not provide any compensation. We understand the need to have a better harmonisation of this regulation, but the method how this should be done is still unclear.

We agree with the argument that as there is no harmonised European energy market and the prices vary amongst the Member States, the differences are too significant to have a completely harmonised scheme.

We do not support any suggestion to create an obligatory, centralised compensation scheme that would redirect auction revenues from the Member States to a central compensation account. Member States' right to decide for which purpose they spend their auction revenues,<sup>12</sup> based on the list mentioned in the Directive<sup>13</sup> and supplemented by the proposal<sup>14</sup>, should be maintained and applied. (The latter point of the proposal makes it possible to use auction revenues for the purpose of compensation, which we can accept.)

Furthermore, as the indirect costs passed through in the price of electricity are important drivers of energy efficiency, limiting the indirect emissions (industrial investment in renewable energy sources), we suggest that if any compensation is given, it should be conditional on maintaining the environmental integrity of the system and to avoid windfall profits.

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<sup>12</sup> Article 3d(4) and Article 10(3) of the current Directive.

<sup>13</sup> Article 10(3) of the current Directive.

<sup>14</sup> Article 1(4), point (c) of the proposal.

## 4.2 Our proposal

We propose to maintain the principle that compensation is voluntary and implemented at national level. Still, to ensure a more level playing field, instead of simply referring to the state aid rules in the new text of the first sub-paragraph of Article 10a(6), we suggest complementing the text with the main rules of compensation to be used by any Member State which decides to provide compensation. These rules should be simple, fully transparent, predictable and flexible enough to be able to handle the differences between the Member States and should maintain the motivation to innovate to avoid indirect emissions.

For example, the following principles can be used to establish the legal background for such a compensation scheme:

- A relative target of electricity consumption<sup>15</sup> per product is determined for the sectors on the carbon leakage list, for example a target matching the best available technology. A relative target is preferred as it does not limit economic growth. Targets should be realistic and take into account local climatic circumstances (for example, differences between energy consumption for heating, cooling and lighting).
- Compensation should be provided only for those installations from the eligible sectors that enter into an agreement with the Member State government and undertake to reach the target of their sector by 2030.
- The amount of compensation can be determined in accordance with the current regulation,<sup>16</sup> so it is based on a product of the relative target and the European energy mix. An alternative can be to use the carbon intensity of the national instead of the European energy mix, as this is more relevant as regards the real electricity costs installations face based on their locality as the electricity market is not harmonised yet.

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<sup>15</sup> This means electricity consumption from the grid or directly from another ETS installation – if an installation decides to generate electricity for itself, it will use either a renewable source (which means zero emission) or it is included in the direct emissions of the installation, covered by the yearly emission report. Electricity bought from non-ETS installations includes no carbon costs to be compensated.

<sup>16</sup> As defined in the second sub-paragraph of Article 10a(6) of the current Directive – the proposal does not change this provision.

- The performance of the installations under the agreement is monitored. For example, installations should biannually submit a verified report on their electricity consumption per product ratio. The target should be pro-rated to 5 sub-targets for the two-year long ‘milestones’. If the sub-target was met in a milestone, the installation continues to be eligible for compensation in the next two years. If the milestone was not met, sanctions should be applied: for example, the compensation received after electricity consumption above the target should be transferred back as a buy-out fee in order to remain eligible for compensation – otherwise the agreement will be terminated.

Such a scheme would provide protection against carbon leakage while stimulating investments.



## POLAND

### **Polish non-paper on national constraints in the light of the review of the EU ETS**

- To begin with, it should be noted that Poland recognizes, in the spirit of the Paris Agreement, that what should be the supreme pro-environment **objective is invariably a slowdown in the increase in the concentration of CO<sub>2</sub> in the atmosphere**, so that temperature at the end of the 21st century does not rise by more than 2°C compared with the pre-industrial period.
- It should be stressed at this point that the effectiveness of the implementation of this objective will depend to a lesser extent on actions taken by the EU due to the diminishing influence of the EU on global emissions and concentrations of greenhouse gases in the atmosphere.
- Poland is in favour of the openness which stems from the Paris Agreement as regards **voluntary selection of methods to accomplish the objectives of the Agreement**, which should be reflected, e.g. in increased flexibility of the instruments used to reduce emissions under the European climate policy.
- Poland wishes to emphasize that it **is a country which actively reduces greenhouse gas emissions** and achieves impressive results in this regard, yet due to economic, historical, technological, geographical and raw material constraints, **we need additional reduction instruments, other than auctioning and high prices of emission allowances within the EU ETS created by administrative interventions or other similar economic tools.**
- **The EU target to reduce greenhouse gas emissions by 40%** (as the EU contribution to the global climate agreement), which was set at the meeting of the European Council on 23-24 October 2014, **should be pursued, taking into account the provisions of the Paris Agreement.**
- Poland wishes to strongly emphasize that **Polish economy is dependent on energy generated using coal and lignite**, and these energy sources belong to natural resources of our country. The share of coal in the energy mix is decreasing, but it still accounts for more than 80% of produced energy, compared with the EU average of 25%. **Poland diversifies its energy mix**, yet this is a long-term process which goes beyond 2030.

- Furthermore, the **Polish economy is growing**, which entails increased demand for electricity and the need to satisfy this demand in a cost-effective manner, while ensuring that environmental objectives, including the reduction of greenhouse gas emissions, are met.
- A sudden and imposed **attempt to change the energy mix** is contrary to the guarantees laid down in the EU treaties and the spirit of the Paris Agreement, and may cause social resistance, hence considerable difficulties in achieving the ambitious objectives of the EU climate policy.
- The fact that Polish production of electricity is based mostly on coal results in **Poland facing major challenges as regards the implementation of the EU climate policy objectives**. However, these objectives can be achieved provided the EU climate policy is pursued in the spirit of the Climate Convention and the Paris Agreement - which do not preclude the use of national solutions to reduce CO<sub>2</sub> emissions.
- Poland is of the opinion that, in accordance with the principles of sustainable development, issues relating to **security of energy production and supplies**, as well as to the affordability **of energy prices for end consumers** should not be marginalized.
- Poland proposes to permanently enter into the framework of the EU climate policy new solutions which will enable **individual Member States to freely determine their energy mixes as guaranteed by EU treaties**, so as to ensure energy security and unvaried availability of energy for customers.
- In this context, Poland also notes the need to set a framework for climate and energy policy, and, as a result, also legal measures to be adopted (including the draft EU ETS Directive), **taking into account their actual impact on the Member State's choice from different energy sources and the general structure of its energy supply**.

- In the context of the problems mentioned above, the EU’s climate policy should create the conditions – within its own instruments (EU ETS) and national ones - necessary to:
  - reflect the spirit of the Climate Convention and the Paris Agreement in the EU policy;
  - **ensure adequate modernization of the energy sector at a rate that does not cause abrupt increases in electricity prices;**
  - **maintain energy security in the Member States and the Union as a whole;**
  - account for sequestration.

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- Therefore:
  - **In the light of solutions implemented or planned recently by some Member States, aimed at a more flexible approach to reducing CO2 emissions, Poland, due to its specific constraints as regards the fuel structure, will need to use system solutions which we will propose and which will contribute to achieving the EU objectives by 2030 in a more cost-effective and flexible way than through the EU ETS only.**
  - Furthermore, the **role of sequestration of greenhouse gases** should be more prominent in the EU’s climate policy. It is important that the EU takes adequate measures to **increase the potential for sequestration** and that accounting for sequestration by forests is enabled. Sequestration of greenhouse gas emissions should be treated on an equal footing with other measures to reduce emissions of these gases.