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Thinking ahead for Europe

The EU ETS structural reform for Phase 4: views from CEPS on the Commission proposal

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Overview

The July 15, 2015 EC proposal for EU ETS structural reform is meant to provide the necessary changes, in the context of the of the 2030 framework for climate and energy policy and the Energy Union, to ensure that the EU ETS can fulfil the role of central pillar of the EU climate change policy, which is how it is referred to in EU documents.

It is therefore only natural that we should look at the overall result of the EU ETS structural reform, which includes back loading, the Market Stability Reserve (MSR) and the current proposal, and ask the question: will the EU ETS, following the current package, be "fit for purpose" i.e. the main driver towards a low GHG economy? While it is too early to answer in a definitive way, serious concerns seem justified regarding the performance of the final "EU ETS product".

A view that is beginning to emerge is that realistically, unless the current package is revised, the EU ETS seems destined to be a tool that can influence operational decisions, but not investments, and one that would address residual reductions, but not be the main driver. Either the EU ETS is strengthened significantly, or carbon pricing will not be the driver. If markets do not drive change, this may lead to a potentially important loss of efficiency.

Significant gains have been accomplished in renewable energy over the past decade, but evidence shows that the gains are attributable, by-and-large, to the RE Directive and national subsidy programmes[1]. The same statement can be made for the reduction in CO2 that have been accomplished in the EU, where a significant proportion cannot be attributed to the impact of the EU ETS.[2]

Since the current package is presented as the final act of the structural reform process, and no one would want to re-open a EU ETS discussion anytime soon, the current proposal may need to consider some additional provisions and/or different provisions, from has been presently proposed.. There are sufficient levers in the current package that could contribute to a more vigorous EU ETS, but some of the options may be politically difficult.

To determine if the EU ETS is "fit for purpose", should the current package be passed "as is", three questions should be answered positively:

1. Is the EU ETS able to provide to 2030 a long-term price signal, which would also drive investment and innovation?
2. Can the EU ETS provide good market functioning and price discovery, and mimic the behaviour of a "natural market " (i.e. flexibility on both the demand and supply sides of the market)?
3. Does it provide effective, but at the same time proportional, protection against the risk of carbon leakage for those sectors of the economy which are open to global competition, while we are still face with an asymmetrical climate change regime?"

[1] According to a report by CDC Climat "[the impact of the EU ETS] has been marginalised in the power sector due to the strong deployment of renewable energy". See CDC Climat. (2014). Research Working Paper • N° 2014 – 17. P.27

[2] See e.g. Sandbag. (2013). "Drifting Towards Disaster". Retrieved via https://sandbag.org.uk/site_media/pdfs/reports/Drifting_Towards_Disaster.pdf

Another way of looking at it is that the overall structural reform of the EU ETS that has been on going over the last few years under different labels was seen as an opportunity to create conditions for a credible long-term carbon price signal, while at the same time ensuring that there were provisions that ensured that those sectors truly exposed to the risk of carbon leakage would not have to pay the cost. What was hoped for was a better price/cost equation.

The MSR can be seen as the part of the structural reform, which was meant to help ensure good market functioning, and price discovery (though changes in free allocation methodology are also needed to accomplish that). The MSR is meant to ensure that there is flexibility on the auctioning portion of the supply side of the EU ETS, and that the overhang resulting from the recession (as well as overlapping policies) would be absorbed. The MSR does introduce that flexibility, but the necessary reform is incomplete without changes to free allocation.

However, the parameters of the MSR, the result of a political compromise, will not eliminate the overhang until well in the mid-2020s, with negative impact on reaching good price discovery. It can be seen as good intentions, but a "timid" outcome.

In a report released earlier this year, CEPS and its partners[3] forecast that, with the parameters as agreed in the May trilogue decision, the surplus would only reach the MSR's 'bandwidth' (the range of 400 – 833 million allowances, where no withdrawal or re-injection takes place) by 2026.

An analysis by ThomsonReuters PointCarbon[4] is slightly more bullish, but still projects that the surplus would remain above the upper threshold of 833 million until 2024, almost halfway into Phase 4, while EUA prices are expected to be around 22 EUR around that time.

As such, the MSR cannot allow for a positive answer to Question 1 and cannot deliver a positive answer by itself to Question 2.

The current proposal, guided by the European Council (EUCO) of October 2014, should want to address a number of issues:

1. Provide a LRF that would re-assure stakeholders that the EU ETS is providing all the necessary contribution to reach the at least 80% decarbonisation goal by 2050
2. Revisit the provisions for addressing the risk of carbon leakage in light of decreasing overall allocation – make sure that there is enough free allocation for those that truly need it, by identifying those that need less, or are not truly at risk.
3. Ensure flexibility on the supply for free allocation
4. Provide additional tools to complement the EU ETS, as needed

The provisions in the proposal are a package, which interact with each other, and impact the areas covered by the three questions listed above. What seems to emerge is that carbon leakage for direct costs is recognized, and provisions included which could form the basis for a good discussion. Unexpectedly, the proposal only provides a mild nod towards addressing indirect costs.

[3] Scanning the Options for a Structural Reform of the EU Emissions Trading System, CEPS, WIFO, Wegener Center, Environment Agency Austria. 19 May 2015

[4] ThomsonReuters PointCarbon EUA Price Forecast 2015

While it can be said that that the proposal follows the EUCO conclusions (even if it does contain some deviation), the real surprise is in the limited degree to which it focuses free allocation. This seems to result, and a deeper analysis is needed, in the continuous need for provisions to cap and reduce free allocation through different instruments, some direct, some indirect.

There is some limited flexibility introduced for the free allocation part of the supply, but those provisions, together with measures to bring MSR volumes to the market, are not helping to reach a positive answer to the question on long-term price signal.

In the sections below we summarise the key changes proposed by the Commission, and review in what way – if at all – they take into account the guidance provided by the European Council. Additionally, we look at how the proposals address the weaknesses and critique of Phase 3 rules and how this relates to previous work of CEPS on these issues.

We first discuss the overall pie of allocation and how it will be shared, before moving to an in-depth discussion of the most important technical proposals on benchmarks, carbon leakage and free allocation rules. The last section reviews some of the other important topics, such as the Innovation Fund, New Entrants Reserve and how market functioning may be impacted.

How to divide a shrinking pie?

Linear Reduction Factor

- 2.2 LRF implemented, as foreseen by EUCO Conclusions
- Implements the 2030 target; but no reference and connection is made to the longer term targets, i.e. 2050

The first and most prominent change from an environmental perspective is the increase of the Linear Reduction Factor (LRF) from 1.74% to 2.2%. In absolute terms this means that the EU-wide cap will decrease by 48 million tonnes annually, up from 38 million.

The strengthened LRF was foreseen by the European Council Conclusions of October 2014, and is a means of achieving the EU's 2030 target of reducing GHG emissions by 40% compared to 1990 (which amounts to a 43% reduction in sectors covered by the EU ETS, compared to 2005).

Given that the 2.2 LRF was already included in the October 2014 European Council Conclusions, as well as the fact that the EU's 2030 target was already submitted to the UNFCCC as part of the EU's INDC, it's inclusion in the Commission proposal was expected.

Nevertheless, the proposal does not link the strengthened LRF or the 2030 target to the EU's long term target for 2050, where it wants to achieve a reduction in GHG emissions of 80 – 95% compared to 1990. Some have questioned whether an LRF of 2.2 is sufficient to put the EU on a credible path towards its 2050 target.

Indeed, the European Commission, in its Impact Assessment for the 2030 Climate and Energy Policy Framework, noted[5] that in some scenarios (contingent on other targets, such as Renewable Energy or Energy Efficiency) a LRF of 2.4 would be necessary to achieve in 2050 a 90% reduction in GHG emissions in ETS sectors, as outlined in the Commissions 2050 Roadmap for a low-carbon economy.

It should also be considered whether it is optimal to embed the specific value of the LRF in the Directive itself: an increase in EU ambition (for example as a consequence of the Paris Agreement) would necessitate another revision of the ETS Directive by the co-legislators.

[5] Eoropean Commission. (2014). Impact Assessment accompanying the Communication on the 2030 policy frame work for climate and energy. SWD(2014) 15 final. pp. 45 & 105.

Auctioning Share

- Kept the same as in Phase 3 at 57%
- Capping free allocation as a way for the Commission to implement Polluter-Pays principle
- Ensures predictability for power sector which mainly buys at auction
- The auctioning share could have been made variable variable (the delta); by choosing not to do so, and capping free allocation, a provision for a CSCF becomes inevitable (found in Art.10a (5) of the EC Proposal.

The Commission's proposal implements a provision in the October 2014 EUCO Conclusions which keeps the same the share of allowances to be auctioned over Phase 4. Therefore, the 57% share of allowances that were auctioned over Phase 3 will remain unchanged for the 2020 – 2030 period. Effectively, this means that a cap on free allocation will be implemented.

For the Commission, putting a cap on free allocation is a way to implement the Polluter-Pays principle. In the Impact Assessment accompanying the Proposal, the risk of carbon leakage is considered a valid justification for temporarily moving away from the Polluter-Pays principle. By ensuring that the amount of free allocation is capped, however, the principle is still taken into account.

It should be noted, however, that the 57% share for auctioning does not translate into the remaining 43% being available for free allocation. Allowances that have been earmarked for other purposes, such as those for the Innovation Fund, will still have to be subtracted.

An additional benefit of fixing the auctioning share is that it increases predictability for operators in the power sector, who mainly acquire their allowances through auctions.

To retain the compensation levels experienced in Phase 3 by the sectors most at risk of carbon leakage, with a cap for free allocation, would only be possible if free allocation would be changed considerably and become more targeted.

As a consequence, all installations and sectors will get fewer allowances for free. While for some installations, there may still be a positive impact on the bottom line if their efficiency improvements are greater than the reduction of their benchmark, their allocations in absolute terms will still drop.

Alternatively, a choice could have been made to make the auctioning share variable – and therefore the delta of what's left after determining free allocation (which could then be dynamically adjusted). By choosing not to do so, it became inevitable that the Commission retained the Cross-sectoral Correction Factor, as found in Art. 10a (5) of the Commission Proposal.

Benchmarks

- Standard flat rate of 1% per year; 0.5% or 1.5% values also possible if carbon efficiency improvements were below or above average: some form of sectoral differentiation
- Period 1 – 2021 – 2025: 15%
- Period 2 – 2026 – 2030: 20%
- Average = 17,5% - CSCF in 2020 = 17.53%

Summary and link to EUCO Conclusions

Benchmark values, which were determined prior to the start of Phase 3 and remained constant, will be updated over the course of Phase 4. The general approach is that benchmark values will be reduced by 1% per year between 2008 and the middle of the period of free allocation. Derogations of 0.5% in either direction are possible if the realised progress in carbon efficiency has been below 0.5%, or over 1.5% annually. Such derogations allow for some form of sectoral differentiation..

The time periods for free allocation will be reduced to five years. For Phase 4, this means that the standard update to benchmarks will be 15% for the first period of free allocation (2021 – 2025) and 20% for the second period of free allocation (2026 – 2030). Taking into account the derogations in either direction, the range becomes 7.5% - 22.5% for the first period, and 10% - 30% for the second period.

Assuming that most sectors will fall into the 1% bracket, the reduction they will face over all of Phase 4 amounts to 17.5%. Incidentally, this is very close to the value of the Cross-sectoral Correction Factor by 2020, which will be 17.53% then. While the underlying rationale between benchmark updates and the CSCF may be very different, their impact on installations is remarkably identical: it cuts the quantities of free allocation. It also reduces the probability that the CSCF will need to be used, or need to be used in a significant way.

The flat-rate updates to benchmarks are indeed a way to implement the EUCO's guidance that "benchmarks will be periodically reviewed in line with technological progress". Nevertheless, the similarities between the CSCF and the average expected benchmark update also seem to indicate that the Commission wishes to keep more or less constant the downward slope with which free allocation has been decreasing since 2013. The 0.5% adjustments will still allow for sectoral differentiation then.

It must however be noted that benchmarks are generally based on actual values and an alternative way to update them would be to revise them. This would however be a fairly laborious undertaking

Does it address Phase 3 criticisms?

The fact that benchmarks are updated using a flat-rate value, also means that the Phase 3 practice of using the 10% most efficient installations within a sector as a starting point still impacts benchmarks over Phase 4. A criticism of this approach was that it did not take into account how installations were distributed around that 10%. The new system does nothing to address this criticism.

CEPS views

CEPS has argued for taking into account technology and investment cycles. While the proposed rules will allow for sectoral adjustments, such adjustments can hardly account for sectoral specificities in technology and investment.

It is also worthwhile to note that the values for the benchmark updates are enshrined in an Article in the Proposal. While this was also the case for Phase 3 benchmark rules, there are elements of equal political and strategic significance, which are instead left for implementing legislation. The baseline years for activity levels being a case in point.

This appears to be inconsistent. While there are limits to what can be delegated from the co-legislators to the Commission (based on the landmark Meroni-ruling of the ECJ, which does not allow delegation of "political and strategic choices"), benchmark updates and activity levels arguably are equally influential in shaping free allocation rules.

Carbon Leakage groups & criteria

- Trade intensity and Emissions intensity are the criteria used and are now combined
- The binary system of in/out of the carbon leakage list is maintained
- New criteria results in significantly fewer sectors covered; yet little changes with respect to the share of emissions covered
- Free allocation will be determined for periods of 5 years (Art. 11 (1))
- No tiered approach with differentiation according to risk
- Conclusion: a few changes, but small impact in terms of focusing the amount of free allocation and freeing allowances

Summary and link to EUCO Conclusions

The EUCO Conclusions clearly stated that free allocation would continue after 2020, but did not go into detail on the topics of carbon leakage groups and the criteria to determine whether a sector is 'at risk'. As such, the Commission has a relative large degree of freedom in shaping these rules, which are crucial in deciding who gets allowances for free.

First and foremost, the Commission retains the current 'binary' system in which sectors are either considered 'at risk' or 'not at risk'. Sectors considered at risk, which will therefore be included in the carbon leakage list (CLL) will be compensated for 100% up to the benchmark. Sectors not considered at risk will still be compensated for 30% up to the benchmark.

In order to assess whether a sector is at risk, the Commission does propose to consider both trade intensity and emissions intensity taken together. This is a change from the current approach, which is using carbon costs, to using carbon intensity.

This is a departure from the current practice, where, for example, it is possible that a sector is considered 'at risk' solely by virtue of its high trade intensity, even if the carbon content of its products is virtually non-existent.

By combining the criteria, the Commission is able to significantly cut down the number of sectors who would be included on the carbon leakage list to about 50. At the same time, and more importantly, the impact on emissions covered is minimal: estimates[6] are that 94% of all ETS emissions will still be covered by the carbon leakage list; a decrease of only 3 percentage points.

Does it address Phase 3 criticism?

With the overall quantity allowances progressively decreasing due to a tightening cap, it has been argued that free allocation should be more targeted. This would ensure that those at the highest risk of carbon leakage would continue to receive allowances, while sectors able to pass on carbon costs to some degree would receive fewer. This would prevent windfall profits.

While the proposed rules do cut down the number of sectors considered at risk, the vast majority of emissions will still be covered. As such, the proposal cannot be considered as ensuring a better targeting of free allocation.

[6] PointCarbon & Ecofys

The decision to not to adopt a tiered approach, with groups differentiated according to risk, ostensibly seems to have been made consciously against the recommendations of the Commission's own Impact Assessment which accompanies the Proposal. In this Impact Assessment, two types of risk-based system with different tiers are described, and both of them score significantly higher in the Commission's own assessment.

The only criterion on which the tiered options do *not* score higher is that of administrative complexity. The fact that an option was chosen which is favourable primarily from a 'keeping things simple' perspective, may point towards the influence of the wider 'Better Regulation' agenda.

CEPS views

CEPS has long argued that it does not make sense to consider carbon leakage risk only on the basis of either trade *or* carbon intensity. Both need to be present in order for there to be a genuine risk of carbon leakage..

At the same time, there could be more transparency as regards why the values were set at the levels included in the Proposal. There is a quantitative threshold of 0.2 or higher (acquired after multiplying trade and emissions intensity values) and qualitative review may lead to sectors also being included on the CLL if they score 0.18 or higher.

While these values as such are clear, the Proposal does not explain why these values were chosen. Had, for example, the quantitative threshold been set at 0.3 instead; the coverage of emissions may have been significantly lower (the reverse also holds true of course).

When it comes to windfall profits, the EUCO explicitly noted in its Conclusions that these should be avoided. In that light, the decision to still grant free allowances (30%) to the sectors not included on the carbon leakage list is surprising. It also amounts to a more lenient provision than in the current Directive, where free allocation no non-CLL sectors would reach zero by 2027.

Even if in absolute terms, the non-CLL emissions are only a small minority, it seems more appropriate to use them for sectors which are actually considered at risk. This is another way in which the proposed new rules are not resulting in targeted free allocation, which would nevertheless be advisable as it would allow free allocation to sectors that need it most, to continue for a longer time even if the overall volume of free allocation which is available is dwindling.

Activity Levels

- More frequent updates means that the production levels used will be the average of the last 4-8 years; this provides for the use of more up-to-date data, but still leaves in place a significant time lag
- No provisions, however, in the proposed Directive; it is a matter for implementing legislation
- Adjustments possible for production increases, which are considered separately from capacity increases
- Symmetrical thresholds suggested for increases and decreases (partial cessation)
- Thresholds up for redefinition?

When it comes to activity levels (or production levels), the EUCO provided guidance through a provision that "future allocations will be better aligned with changing production levels". However, as production levels are a matter for implementing legislation, the Commission Proposal contains no provisions on this topic.

The supporting documentation reveals that there will be two updates during Phase 4. For the first period of free allocation, the average production levels that will be used are from 2013 – 2017. For the second period, the average production levels will cover the period 2018 – 2022.

The general rule therefore seems to be that the 5-year average of the preceding 4-8 years of production will be used for any period of free allocation. Just as with the benchmark updates, this is in principle a system which could be continued past 2030 and Phase 4 as well, even if the Proposal only cover the 2020 – 2030 period. Consideration could be given to including this as a principle in an Article in the Directive, as it would add clarity and regulatory predictability beyond Phase 4 as well.

Another crucial part of allowing for better alignments with changing production levels is the fact that there may be annual adjustments for production increases. The allowances for this adjustment would come from the NER, discussed below. This would allow free allocation to become more dynamic, provided that the thresholds used to trigger adjustments are set at a level that allows this provision to play an operational role.

In the current system, only downward annual adjustments are possible (so-called partial cessations). By allowing adjustments to the upside as well, the Commission addresses in part one of the biggest criticisms of allocation in Phase: that of the rigidity of supply.

The Commission plans to have symmetrical rules for both increases and decreases. What will be crucial in how the system operates in reality is how the thresholds will be defined. The current rules for partial cessations contain thresholds which lie very far apart and which make the system susceptible to strategic gaming behaviour. I.e. for an adjustment to take place, production has to decrease with more than 50% before free allocation quantities are adjusted.

CEPS has long argued for more flexibility in free allocation. A careful redesign of the thresholds for production increases and decreases is instrumental in achieving this. In particular, the closer these thresholds lie to one another, the more 'dynamic' and responsive the system becomes.

In one of the options described in the Impact Assessment, corresponding to ‘better alignment with changing production levels’, a value of 15% as a lower threshold is mentioned as a possibility. While this would already be a clear improvement over the current trigger at 50%, an even lower threshold, possibly in the single digits, may be advisable.

Other issues:

New Entrants Reserve

- Somewhat smaller in size to the Phase 3 NER (from 480 million to 400 million)
- Allowances in NER may be used for production increases
- New NER could help make free allocation more dynamic

The New Entrants Reserve provides for allowances to be allocated freely to new installations (or new entrants), installations which increase their capacity, and for the first time, installations which increase their productions (without necessarily adding to capacity).

When it comes to the composition of the NER, the Phase 4 NER will contain about 80 million fewer allowances (400 million, down from 480 million in Phase 3). 250 million of those will come from the MSR, while another 145 million will come from Phase 3 unallocated allowances not captured by MSR deal (namely allowances left over from allocation to non-CL sectors, which see their allocation dwindle to 30% by 2020).

At the same time, Phase 4 will also be two years longer than the current phase. Nevertheless, with most of the Phase 3 NER being left unused and with the possibility of allowances flowing back into the NER, the smaller size may not pose a problem.

The most important aspect of the New Entrants Reserve in Phase 4 is that allowances from the NER may be used for production increases. As outlined above, this could be an important step in making free allocation more flexible, thereby ensuring better alignment with changing production levels.

There is another way in which the proposed Phase 4 NER is dynamic in character. Whereas in Phase 3, unused allowances from (partial) cessations ostensibly would return to the market via auctioning at the end of the phase (before this was addressed by the MSR), in the Phase 4 they would instead be moved back into the NER, where they could again be used for new entrants or production increases.

The fact that allowances in the NER originate in the MSR shows that volume that had been taken off the market is now returned, which will make the workof the MSR more challenging.

Indirect Carbon Costs

- EUCO said to that “both direct and indirect costs will be taken into account, in line with EU state aid rules”.
- ‘**May’** will be changed into ‘**Should’** when it comes to indirect carbon cost compensation.
- Member States will not be in breach of EU law should they decide not to grant compensation.
- Arguably, this is the provision where the EC proposal diverges most from the EUCO Conclusions. While in some way, indirect carbon costs are “taken into account”, any change in Member State practices seem highly uncertain.

- CEPS has argued for more harmonisation in indirect carbon cost compensation. The EC proposal cannot be seen as addressing the issue currently.

The European Council stated in its Conclusions that "both direct and indirect costs will be taken into account, in line with EU state aid rules". The Commission translates this in its proposal by suggesting a change to the language on indirect carbon cost compensation: 'may' is changed into 'should'.

While this is a politically stronger statement, it changes nothing in a legal sense. Member States will not be in breach of EU law should they decide not to grant compensation. Even if it leads to more Member States granting such compensation, it remains subject to State Aid rules. This means that any compensation would still be granted on an ex-post basis, and that – following the State Aid Guidelines – the aid intensity cannot be 100% and should be tapered over time.

As indirect carbon cost compensation remain at the discretion of Member States, the risk of distortion in the internal market is significant. CEPS has argued that an EU-wide harmonised system would be better in this respect.

Arguably, this provision is also the one where the EC proposal diverges most from the EUCO Conclusions. While in some way, indirect carbon costs are "taken into account", any change in Member State practices seem highly uncertain.

Innovation Fund

- A successor to the NER300, with the more sensible name 'Innovation Fund', will be in place in Phase 4. It will consist of 450 million allowances, 50 million of which come from the MSR.
- 60% funding threshold (up from 50%)
- Industrial innovation projects also eligible
- Allowances are taken from share of free allocation (as auctioning is fixed at 57%). In phase 3, the allowances came from the NER.

The new Innovation Fund – the successor to the NER300 – allows for the support of innovation projects in renewable energy, carbon capture and storage (CCS). In addition, industrial innovation projects are also eligible for the first time from Phase 4 onwards.

If the governance structure remains similar to that of the NER300, the European Investment Bank (EIB) will be responsible for the monetisation of allowances and disbursement of funds, while Member States primarily are responsible for project selection.

The changes to the governance of the Fund proposed so far are minor, but not unimportant. The Commission proposes an Innovation Fund consisting of 450 million allowances, 50 million more than the European Council asked for when it called for an 'NER400'. These extra allowances will come from the MSR. It should also be noted that the majority of allowances will come from the overall share of allowances available for free allocation, and not from the NER as was the case in Phase 3.

Also as foreseen by the EUCO Conclusions, Industrial innovation projects will also be eligible for funding. The Commission, in addition, proposes that funding from the Innovation Fund can cover up to 60% of the costs of a given project (up from 50% in the NER). As innovation projects are

inherently risky (yet with potential big pay-offs), and taking into account the general private investment climate, such a higher threshold appears to be a good way of attracting more private capital.

Market impact

- The outcome of the MSR debate was that it included the transfer of a significant number of 'unallocated' allowances to the Reserve. With this proposal, some of these will be appropriated for other uses while some allowances were not captured by the deal:
- 250 million allowances for the NER
- 50 million allowances for the innovation fund
- These allowances will now either be allocated for free, or monetised by the EIB as opposed to them being auctioned only if the MSR provision for re-injection would be triggered

The Market Stability Reserve is meant to systematically address surpluses arising due to economic cycles and from policy overlaps (such a renewable energy targets). The result is meant to better reflect the workings of a 'real' market.

The Commission proposal suggest provisions that detract from the already not very convincing parameters of the MSR, by bringing back to the market supply that was meant to be withheld. Nevertheless, some of the proposed transfers also benefit flexibility elsewhere in the market, such as the ones proposed for the new NER.

The deal on the MSR included the transfer of a significant number of 'unallocated' allowances to the Reserve. With this proposal, some of these will be appropriated for other uses while some allowances were not captured by the deal. The preceding sections on the NER and Innovation Fund already alluded to a certain number of allowances being moved from the MSR, for use in these earmarked funds.

250 million allowances will be used to as a starting point for the NER, while 50 million allowances will be used for Innovation Fund. These allowances will now either be allocated for free (for new entrants or capacity and production increases), or monetised by the EIB as opposed to them being auctioned once they would be re-injected from the MSR.

This also means that there is an impact for Member States, who will have to forego on the auctioning revenue of these allowances. At the same time, the number of allowances in circulation may be higher than would have been the case if they remained in the MSR. This could also have consequences for the price signal of the EU ETS.