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European Union
"Climate & Energy Package"

February 2008

European industry faces an extraordinary and immediate challenge: adjustment to fundamental new European Union (EU) regulations designed to accelerate transition to climate-friendly technologies and practices. In tandem with "prohibitive" low carbon legislation, the EU has started to lay out a corresponding inducement regime of incentives and business opportunities.

During 23-29 January 2008 the European Commission of the EU published a major package of proposed legislation to combat climate change and improve the EU's energy security and competitiveness. This will implement specific targets endorsed by the European Council in March 2007.

Overview

The package comprises the following measures:

- *COM(2008)16*: Amendments to the Emissions Trading System (ETS) Directive to "broaden and strengthen" the ETS Phase III from 2013;
- *COM(2008)17*: Decision setting differentiated limits on greenhouse gas emissions (GHG) for each Member State for sectors not covered by the ETS (transport, buildings, services, smaller industrial installations, agriculture and waste), where limits are to be met by 2020;

  These two proposals will ensure the EU as a whole reduces its emissions to at least 20% below 1990 levels by 2020.

- *COM(2008)19*: Renewables Directive setting differentiated national targets for the share of renewable energy in each Member State's total energy consumption, where levels are to be reached by 2020; includes criteria to ensure biofuels are produced sustainably;
- *COM(2008)18*: Directive on the Geological Storage of Carbon Dioxide establishing a legal framework to ensure the safe and environmentally sound use of carbon capture and storage (CCS); accompanied by COM(2008)13: Communication on the technical and market demonstration and deployment of CCS;
- Commission Decision "revising, broadening, intensifying and easing administrative burdens" in relation to the Guidelines governing State Aid granted for environmental purposes;

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- *COM(2008)30*: Overall Communication setting out the Commission vision for opportunities from climate change 2008-2020.

Background and significance of the package

EU policy for environment, industry, competition and global leadership has been transformed by Sir Nicolas Stern's October 2006 *Report on the Economics of Climate Change*, which concluded:

> *"There is still time to avoid the worst impacts of climate change, if we act now and act internationally".*[1]

In March 2007 EU Heads of State and Government committed to taking up this challenge at both domestic and global level.[2] Three targets were set, for achievement by 2020:

- 20% cut in GHG emissions (on 1990 levels);
- 20% increase in use of renewables in the overall EU energy mix, including 10% vehicle biofuels (on 1990 levels);
- reduce primary energy use by improving efficiency by 20% (on 1990 levels).

Proclaimed by Commission President José Manuel Barroso as "20-20-20 by 2020",[3] these commitments will shape EU regulatory policy and strategic spending into the next mandate.

Key Member States have already set additional national targets – Germany for example intends to reduce emissions by 40%. Other jurisdictions look to Europe as a regulatory trendsetter and the EU is increasingly ambitious to achieve market leadership as a pioneer "low carbon economy".

The current package is to be understood amid a wider set of measures. At international level, the December 2007 Conference of the Parties to the Kyoto Protocol adopted the "Bali Roadmap" for negotiations on a new far-reaching global agreement on climate change for 2050, to conclude at Copenhagen in December 2009. The EU's 20% by 2020 emissions reduction target will increase to at least a 30% commitment under this international agreement.

At EU level, the upcoming European Council meeting on 13-14 March 2008 will adopt climate technology funding mechanisms under the Strategic Energy Technology Plan (SET Plan).

On 23 January 2008 Barroso told the European Parliament:

> *"There is a cost, but the cost is manageable. The proposals demonstrate that the targets agreed last year are technologically and economically possible and provide a unique business opportunity for thousands of European companies."*[4]

Business also sees opportunities, with the EU Corporate Leaders Group on Climate Change welcoming the package:

> *"The benefits of strong, early action on climate change outweigh the costs of not acting. [We] also believe that new markets for low carbon technologies, worth billions of Euros, will be created if the EU acts on the scale required".*[5]

A Commission Joint Impact Assessment SEC(2008)85/3 on the package summarises the market analysis.[6] This argues that the measures will bring important long and short term economic benefits: notably, if the GHG and renewables targets are met, oil and gas imports should fall by some 0.3% of GDP, translating into import savings of €50 billion.[7]

The EU economy would also be less exposed to disruptions in supply and price shocks resulting from having supply concentrated in a limited number of countries ("energy security").[8]

Legislative process, timing and politics

The various policy proposals in the package are closely interlinked. However, each draft Directive and Decision must be approved individually in the Council (by Member States) and in the European Parliament. This process is expected to be completed by June 2009, with the legislation coming into effect from 2013.

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[1] Executive summary, http:www.hm-treasury.gov.uk/media/4/3/Executive_Summary.pdf, full report, http://www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm

[2] The Commission adopted these targets in January 2007, calling on the Council and European Parliament to adopt and support a radical approach. The European Council invited the Commission to come forward with concrete proposals, including how efforts could be shared among Member States.

[3] Council Conclusions, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ec/93135.pdf

[4] Barroso Speech/08/34.

[5] http://www.cpi.cam.ac.uk/programmes/energy_and_climate_change/clgcc/members.aspx

[6] http://ec.europa.eu/energy/climate_actions/doc/2008_res_ia_en.pdf

[7] The Commission notes that these savings are based on "a conservative estimate of an oil price of around $60 per barrel. If the current high oil prices of almost $100 per barrel continue, the benefits will be considerably higher".

[8] Commission Memo/08/34.

The State Aid Guidelines will apply with immediate effect following their publication in the *Official Journal of the EU* in February 2008.

This memorandum outlines the key provisions of the January 2008 proposals. We conclude with an initial analysis of the applicable legislative procedures, likely timelines and key political players.

Emissions Trading System (ETS)

Established by Directive 2003/87/EC, the ETS provides "a scheme for GHG emission allowance trading within the EU" to implement the Kyoto Protocol. After teething troubles in Phase I trading period, the ETS is now entering its Phase II for 2008-2012.[9]

Under the Commission's proposed amendments for Phase III from 2013, the ETS carbon market will expand to cover almost half the EU economy. Emissions allowances will also move from free allocation to auctioning.

Key elements of the new Commission proposal include:

- An 8 year compliance period for Phase III (2013-2020), unlike the current 5 year Phase II (2008-2012);
- An EU-wide cap, replacing the 27 national caps set by Member States and approved by the Commission; the cap limits emissions to 21% below 2005 levels with the annual cap to decrease along a linear trend continuing beyond Phase III;[10]
- New industries (aluminium and ammonia producers) and gases (nitrous oxide and perfluorocarbons) to be included in the ETS;[11]
- N_2O emissions from nitric acid and adipic acid production are included in the ETS;
- Industrial plants emitting less than 10,000 tonnes of CO_2 can be exempt from the ETS;[12]
- 100% auctioning of allowances to the power sector from 2013, with phasing in of 100% auctioning during 2013-2020 for other sectors (exceptions for sectors judged to be significantly exposed to "carbon leakage" international competition from producers in countries without comparable CO_2 constraints);
- EU harmonisation of auctioning modalities in a Regulation to be agreed in 2008;
- Member States will carry out ETS auctions and accrue the auction revenues;[13]
- Under internal market rules, any EU operator will be able to buy allowances in any Member State;
- Tight restrictions on imports of Clean Development Mechanism (CDM) and Joint Implementation (JI) emissions reduction credits in the absence of an international agreement, with imports in Phase III limited to the carry over of unused imports from Phase II.[14]

The Commission also intends to adopt new Regulations governing the monitoring, reporting and verification of ETS emissions.

Interim review

In 2011, the Commission will issue a report determining what action will be necessary to protect the interests of EU industry: notably, whether to postpone auctioning. Estimating that revenues from auctioning could amount to €50 billion annually by 2020, the proposal stipulates that Member States "should" use 20% of these revenues for specified "green innovation" in renewables, CCS and R&D.

Burden-sharing within the EU

Under the proposals, Member States will bear different CO_2 emissions-cutting burdens. Reflecting their desire to catch up with standards of living in western Europe, 12 less economically developed Member States (including almost all of the new Member States since

[9] The ETS cap on carbon emissions is allocated among companies according to historic output. Putting a price on an emissions permit that can be sold on, it aims to incentivise emissions reductions and reward efficient industries. Today more than 90% of permits are given away, but after the reform the bulk will be auctioned by governments.

[10] From 2.1 billion tonnes of CO_2 in 2005 to 1.7 billion tonnes by 2020. Annual caps will not reduce flexibility for individual installations as allowances remain valid throughout the trading period and any surplus allowances can be "banked" for use in subsequent trading periods.

[11] 5% of the total quantity of allowances will be put into a reserve for "new entrant" installations or airlines that enter the system after 2013. Allocations from this reserve should mirror the allocations to corresponding existing installations. Any allowances remaining in the reserve will be distributed to Member States for auctioning.

[12] Large numbers of installations emitting relatively low amounts of CO_2 are currently covered by the ETS and concerns have been raised over the cost-effectiveness of their inclusion, causing the Commission to propose, under certain conditions, to allow Member States to remove these installations from the ETS. Installations concerned are those with a rated thermal input below 25MW whose reported emissions were lower than 10,000 tonnes of CO_2 equivalent in each of the 3 years preceding the year of application, and may be excluded from the ETS only if measures are in place that will achieve an equivalent contribution to emission reductions.

[13] The proposal provides a basis for adopting a Regulation (Comitology procedure) to provide the appropriate conditions for ensuring efficient, coordinated auctions without disturbing the allowance market.

[14] In the event of an international agreement, half the additional effort can be met with imports; if an agreement is delayed, the EU will negotiate bilateral agreements for project credits whose import volume remains unclear.

2004) are permitted to increase their GHG emissions by up to 20% from 2005 levels.[15]

International competition

To date, China and the US, at federal level, have not asked their industries to meet mandatory GHG emission targets. In 2011, the Commission will consider whether to apply compensatory border tariffs to energy intensive goods, depending on an international climate change agreement.

Meanwhile, the EU and Canada are in talks to link their CO_2 emissions trading schemes.[16]

Non-ETS Emissions

Accompanying the ETS amendment, a Decision proposes burden-sharing among the Member States for efforts to meet the EU's unilateral greenhouse gases (GHG) reduction commitment in sectors not covered by the Kyoto Protocol/the ETS to reduce emissions to 10% below 2005 levels by 2020. These sectors (cars, heating, transport, buildings, services, smaller industrial installations, agriculture and waste) currently represent 60% of EU total GHG emissions.

- The Commission has proposed a specific target for each Member State to reduce emissions in accordance with a linear path toward 2020; however, Member States are allowed to borrow 2% of their allotted emissions from the next year and can bank excess advance emission reductions for the following year;[17]
- Member States will define and implement their own policies and measures, within the limits of EU-wide measures (including energy efficiency standards, CO_2/cars, waste legislation);
- Countries will not be able to appeal against the annual targets once they are set, but the co-decision procedure ensures that there is some room for negotiation in the legislative process. The intention is for the targets to be finalised by Spring 2009.

Penalties for failure to meet these new targets will be infringement procedures under Article 226 EC Treaty.

Renewables

Draft Directive setting differentiated national targets in the share of renewable energy for Member States' total energy consumption, to be reached by 2020. The proposal also lays down criteria to ensure biofuels are produced sustainably.

- Individual binding targets for Member States which can be met with a mix of renewable production coming from electricity, heating/cooling and biofuels (at least 10% of all transport fuel demand);
- Under a framework for cross-border trading, Member States which are on track to meet their targets can allow projects to export certificates to other Member States, thereby helping them meet their own target.

This means an approximate annual increase in capacity across Europe of:

- **9% for wind (less than half than the current growth rate, although future sites are expected to be more challenging in some countries);**
- **19% for solar thermal (close to the current growth rate);**
- **22% for biomass electricity (a doubling of the current growth rate).**

Carbon Capture and Storage (CCS)

The March 2007 meeting of the European Council also committed the Commission and Member States to plan for investment in 10-12 full-scale CCS carbon abatement technology demonstration plants by 2015. The package proposes a Directive to establish the legal regime for the geological storage of CO_2, and a Communication on Supporting Early Demonstration of Sustainable Power Generation which sets up priorities and an institutional process for raising up to €5 billion public-private Member State and EU-level funding during 2008-2012.

Acknowledging that CCS is not technologically mature, and has yet to be deployed at market costs,[18] the Explanatory Memorandum to the Directive states that CCS will "not be mandatory at this stage" but this option

[15] CO_2 targets for each Member State: Denmark -20%; Ireland -20%; Luxembourg -20%; Sweden -17%; Austria -16%; Finland -16%; Netherlands -16%; United Kingdom -16%; Belgium -15%; France -14%; Germany -14%; Italy -13%; Spain -10%; Cyprus -5.0%; Greece -4.0%; Portugal +1.0%; Slovenia +4.0%; Malta +5.0%; Czech Republic +9.0%; Hungary +10%; Estonia +11%; Slovakia +13%; Poland +14%; Lithuania +15%; Latvia +17%; Romania +19%; Bulgaria +20%.

[16] *Directive 2003/87* already allows for linking the ETS with other industrialised countries that have ratified the Kyoto Protocol. The Commission is proposing to extend this to include any country or sub-national administrative entity (e.g. California) with a compatible cap-and-trade system. Where such systems cap absolute emissions, there would be mutual recognition of allowances.

[17] The Commission has used GDP/capita as the main criteria in setting different Member State targets.

[18] The biggest CO_2 storage projects currently involving European companies are the Sleipner project in the North Sea (Statoil) and the In Salah project in Algeria (Statoil, BP and Sonatrach). Other demonstration projects underway are the Vattenfall project at Schwartze Pumpe in Germany which is due to be operational by mid-2008, and the Total CCS project in the Lacq basin in France.

may be considered in light of fuller technological and carbon market data in 2015. It specifies suitable storage sites (depleted oil and gas fields, saline aquifers), safety and liability mechanisms, arrangements for permitting, and the required technical assessments of storage and transport options. It is expected that the Directive will be incorporated into the EEA Agreement and apply to the EU27 and – crucially – Norway.

An ongoing stakeholder initiative supported by the Commission, the European Technology Platform on Zero Emission Fossil Fuel Power Plant (ETP-ZEP),[19] has identified some 15 full-scale demonstration projects that could go ahead once the necessary economic framework is in place.

Environmental State Aid

The 2001 Environment State Aid Guidelines (EAG) have not resulted in extensive deployment of climate-friendly technology. The January package aims to reverse this situation, with the Commission now actively favouring environmental State Aid projects. The new EAG broadens the scope of aid projects, increases aid intensities and eases administrative burdens with effect from February 2008.[20]

- The current EAG allows State Aid for investment to adapt to new EU environmental standards and aid for operating costs that can be shown to make a significant contribution to protecting the environment. The detailed scope of these eligibilities is greatly increased by the new rules.

- Under the new EAG aid intensities also increase considerably: ranging from 30-40% to 50-60% for large enterprises and from 50-60% to 70-80% for small enterprises.[21] **It will be possible to grant 100% aid following a competitive tender procedure**.

- To ease administrative burdens, a new "balancing test" will treat applications either under a standard assessment or a new detailed assessment category for large aid amounts to individual enterprises. Schemes involving tax exemptions and reductions will only be assessed at the level of the scheme, e.g. individual enterprises will not be subject to a detailed assessment.

The following large aid awards must be notified individually to the Commission:

- Investment aid where the amount exceeds €7.5 million for one undertaking;

- Operating aid for energy saving where the amount exceeds €5 million per undertaking for 5 years;

- Operating aid for the production of renewable electricity and/or combined production of renewable heat, when this is granted to renewable electricity installations in sites where the resulting renewable electricity generation capacity exceeds 125MW;

- Operating aid for the production of biofuels when this is granted to a production installation in sites where the resulting production exceeds 150,000 tonnes per year;

- Operating aid for cogeneration where this is granted to a cogeneration installation with the resulting cogeneration electricity capacity exceeding 200MW; aid for the production of heat from cogeneration will be assessed in the context of notification based on electricity capacity.

General Block Exemption

The easing of EAG administrative provisions is linked to the future General Block Exemption Regulation (GBER) to be adopted by the Commission before Summer 2008. This will relieve Member States from the obligation to notify certain aid measures, facilitating key investments.

Legislative Process, Timing and Politics

The Directives and Decision in the package come under the co-decision procedure, with the Council and European Parliament (EP) as co-legislators who must both agree the final text.

The Commission hopes to see the package adopted on a tight timetable by the end of 2008. More realistically, the legislation is expected to be adopted in early 2009, before the EP elections in June 2009. The current Slovenian Council Presidency and successive French, Czech and Swedish Presidencies as well as the main EP political groups and committees concur in seeking an agreement at first reading.

The EP intends to appoint rapporteurs at the end of March 2008 to lead committee work on the various parts of the package. This division of appointments between the political groups and committees is expected to involve decisive trade-offs between measures formally

[19] www.zero-emissionplatform.eu/website/

[20] State aid must fulfil certain criteria and be authorised by the European Commission. The Commission issues guidelines and frameworks to help Member States by announcing in advance which measures it will consider compatible with the common market, thus speeding up their authorisation.

[21] Where an investment to improve on Community Standards or to improve the level of environmental protection, in the absence of standards, involves eco-innovation, a further 10% aid bonus can be granted.

part of the package and parallel legislation – notably the CO_2/cars Regulation.

Additionally, the package will be discussed at Heads of State and Government level during the meeting of the European Council on 13-14 March 2008, with the aim of accelerating political impetus for its rapid adoption and facilitating funding lines.

Key arguments already raised

Key arguments already raised by the Commission, in the EP plenary and in positioning between Member States include:

- Implementing the package will create a first mover advantage for the EU in low carbon technologies, boosting the competitiveness of hi-tech sectors.[22]
- The package will entail considerable economic effort and increased investment in renewable energy. Power plants, appliances and transport must be made more energy-efficient. **The Commission estimates the direct cost of mitigating emissions in the energy system and non-CO_2 emissions in all sectors at approximately 0.6% of GDP (or €90 billion) in 2020, if the EU achieves the required emission reductions internally. CO_2 credits acquired through the Kyoto Protocol's flexible mechanisms would reduce this to 0.45% of GDP**.[23]

[22] Commission Memo/08/34.
[23] Commission Memo/08/34.