

Technical note ETS – investment conditionality for free allocation

Problem statement

With competition from state of the art installations in South Asia, companies not investing in the short term will ultimately disappear. Irrespective of carbon costs. While free allocation has brought ETS far, it now becomes a scarce resource risking to be spent on delaying an exit, rather than steering towards investments in modernization. Moreover, scarcity will negatively affect EU industry across the board, notably companies who have invested heavily. With fierce competition, this is something also the frontrunners cannot afford.

Policy objective

Free allocation should be directed towards installation that have invested in decarbonization. A tight but sufficient time frame should be provided so that a cut in free allocation can be avoided, also keeping the door open for initial laggards who demonstrate substantial performance improvements. This should also allow for governments to provide for the necessary conditions to decarbonize, such as grid capacity.

Stronger incentives for near-term industrial decarbonization investments are needed to reduce fossil fuel dependence and preserve industrial competitiveness. The current ETS price alone may not sufficiently reflect the residual abatement costs of key decarbonization technologies. Further incentives via free allocation would help in creating the right conditions.

Measures should be objective, verifiable and minimize administrative burden. This can be done by basing conditionalities on actual GHG emissions intensity performance relative to existing benchmark data. Methodologies based on emission intensity are tried and tested, and are sufficiently quantitative to ensure the rules are applied equally. This avoids distortions in the intra-EU playing field.

Suggested policy design

Measure 1: 20% conditional allocation

- As part of the upcoming revision regarding the free allocation in 2031 – 2035, performance targets are established based on the 2021/2022 GHG emissions intensity data. The targets should be communicated well in advance and in absolute terms. Setting targets in absolute terms would be preferable to targets in relative terms (e.g. top X%), to provide investment certainty and to encourage more installations to invest. The target can for example be set at the median emission intensity in the relevant benchmark category.
- 20% of the free allocation in 2031 – 2035 is conditional – granted only if one of the following criteria apply:
 - 1) Sufficient performance: the subinstallation's GHG emissions intensity in 2032 - 2033 is lower than the performance target.
 - 2) Sufficient performance Improvement: between 2026 and 2033, the GHG emissions intensity of the installations as a whole has dropped by at least 20%, and supported by commissioned decarbonization investments. The latter would require a degree of qualitative assessment. The aim is to avoid awarding partial closures of old production lines, but rather rewarding actual investments.
- The above criteria would be assessed in 2034. The free allocation for 2031-2033 will be allocated in full to avoid liquidity issues, although the conditional free allocation is preliminary.

Should the conditions not be met, then the excess allocation will be withheld from the allocation received in 2034 and 2035, so that the total free allocation 2031 – 2035 corresponds to 80% free allocation.

Measure 2: widening CSCF exemption

- To incentivize frontrunners and provide investment certainty, the existing CSCF exemption could be granted to installations meeting a predefined absolute emissions-intensity threshold (for example, the applicable 2021–2025 benchmark value). This would enable investors to determine ex ante the efficiency level required to qualify, thereby strengthening the business case for timely decarbonization investments.
- The resulting allocation requirement could be sourced from installations that appear uninclined to invest, for instance by taking the 2013-2020 benchmark as a reference, which is an emissions intensity which is reasonably achievable.