

# European Project Mechanism

The way to increase ambition in non-ETS sectors

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## 1. What is the Climate Action Regulation and why does it need to be the focus of the European Climate Law?

The Climate Action Regulation (Regulation EU 2018/842)<sup>1</sup> covers 58% of all EU GHG emissions, a percentage that is growing.<sup>2</sup> It includes sectors such as road transport, buildings, agriculture, small industry installations and waste or in other words, most of the everyday life basic activities of European citizens. Legally speaking, the regulation includes sectors not covered by the EU Emissions Trading System (EU ETS) (Directive 2003/87/EC)<sup>3</sup>, which mostly covers large industry, power production and intra-EU aviation. The EU ETS, despite it being the focus of EU climate debates, covers around 40% of all EU GHG emissions<sup>4</sup>, considerably less than the CAR. While the EU ETS has enjoyed a disproportionate attention from lawmakers to date, it is time for the European Climate Law to make the bulk of EU emissions the star of the EU Green Deal. As the very name of the Regulation suggests, this piece of legislation is the key to a successful implementation of the Paris Agreement and therefore needs to take center stage in the efforts ahead.

Currently, the CAR has an overall target of -30% GHG reductions by 2030 compared to 2005 levels, while the ETS has an overall target of -43%. Both combined would deliver a reduction of -40% by 2030 in comparison to 1990 levels. Based on the Commission's own modelling, assuming all policies deliver their full potential, the EU will overshoot this target by a large margin and therefore increasing it to a level of relevance is not just a matter of international credibility, but most importantly a matter of ensuring the 2 carbon budgets are sufficiently stringent to deliver cost effective decarbonisation. In the context of the European Green Deal<sup>5</sup>, the European Commission has suggested to increase the overall ambition to -50% by 2030 (vs. 1990), and to explore the possibility to increase it to -55%. In order to increase the overall target, ambition needs to be increased both in the ETS and the CAR.

While the obligations of the ETS fall on the specific industrial operators, the CAR sets targets for each EU member state. The 2030 CAR targets are extremely diverse, ranging from 0% by 2030 (vs. 2005) for the member state with the lowest GDP per capita in the EU (Bulgaria) up to -40% for countries on the other end of the spectrum (Sweden and Luxembourg). While the CAR targets are very different across member states, the cost-effectiveness of reducing emissions is also very different among member states and most often, inversely related to the reduction targets in such a way that the cheapest reduction potential is located in the countries with the lowest targets who may therefore lack the incentive to fully reap the benefits of accelerating reductions.

| 2030 Climate Action Regulation targets vs. 2005 |               |                    |                 |
|---|---------------|--------------------|-----------------|
| Belgium: -35 %                                  | Greece: -16 % | Lithuania: -9 %    | Portugal: -17 % |
| Bulgaria: -0 %                                  | Spain: -26 %  | Luxembourg: -40 %  | Romania: -2 %   |
| Czech Rep.: -14 %                               | France: -37 % | Hungary: -7 %      | Slovenia: -15 % |
| Denmark: -39 %                                  | Croatia: -7 % | Malta: -19 %       | Slovakia: -12 % |
| Germany: -38 %                                  | Italy: -33 %  | Netherlands: -36 % | Finland: -39 %  |
| Estonia: -13 %                                  | Cyprus: -24 % | Austria: -36 %     | Sweden: -40 %   |
| Ireland: -30 %                                  | Latvia: -6 %  | Poland: -7 %       | UK: -37 %       |

According to an analysis by the European Environment Agency, 18 countries would likely fail to meet their 2030 CAR targets<sup>6</sup>. This translates into existing targets creating implementation difficulties up to 2030 for a lot of member states, while also giving others a free ride to 2030 hence pushing them against a very steep curve of reductions going from 0% (by 2030 vs. 2005) in some cases to at least -80% over the course of just two decades (2030 to 2050), if Europe is to reach climate neutrality by 2050. Such a trajectory seems highly challenging. In comparison to EC analysis, it shows that special attention should be given to CAR sectors if the EU is going to overachieve existing targets and further increased ambition.

The availability of technologies and know-how across Europe is very different. The same applies to the costs of investment, such as e.g. the cost of labour. Additionally, the starting point might be very different in sectors such as transport (e.g. older and less fuel efficient car fleet) and buildings (e.g. older and less efficient building stock). Therefore, at equal investment, higher reductions can be delivered.

This paper suggests a way to create the right enabling environment to ensure that all member states meet their CAR targets together, and emission reductions are as cost-effective as possible.

## 2. The European Climate Law requires a solid European Project Mechanism

The upcoming Climate Law, expected in the upcoming weeks, is the right legislative instrument to ensure that reductions within the sectors covered by the Climate Action Regulation would take place in the most cost-effective, advanced and fair way.

Currently, the CAR allows member states to trade surplus allocations. Specifically, article 5, paragraph 7 states:

*“Any transfer of annual emission allocations pursuant to paragraphs 4 and 5 [surplus allocations] may be the result of a greenhouse gas mitigation project or programme carried out in the selling Member State and remunerated by the receiving Member State, provided that double counting is avoided and traceability is ensured.”*

Even if it is a step in the right direction, it doesn't guarantee that trading between member states will take place.

Therefore, we suggest the creation of a European Project Mechanism (EPM). Such a system would have many advantages:

1. **Technology and know-how** would be transferred across the Union space, especially when certain member states focus on specific sectors. This would have a catalysing effect, helping member states with less resources to be better prepared to implement 2050 targets.
2. **Decrease the overall costs**, delivering more emission reductions at equal cost, given that reductions would take place wherever they are the most cost-efficient.
3. **Revealing price**: under the Effort Sharing Decision (running up to 2020), member states could also trade allowances. Until today<sup>7</sup> only two member states (Bulgaria and Malta) have traded with each other. However, there is a total lack of transparency<sup>8</sup> on the price paid per tonne of CO2 built, nor how the received investment will be spent.
4. **Collectively head towards climate-neutrality**: given that countries with the highest cost-effective potential are also the ones with the lowest targets by 2030, they need to go beyond their current targets if they are going to start a trajectory towards 2050

climate-neutrality. Otherwise, the effort required in just two decades would make reaching climate-neutrality particularly challenging.

- 5. Creative momentum to increase ambition:** the creation of the EPM would create the right political momentum and framework that would allow many member states to reconsider the increase in their CAR targets, having a clear understanding on where the opportunities lie, and at what price.

### 3. How could the European Project Mechanism work?

The main challenge of the EPM is to create the right framework to make it happen. We foresee three different parties to be involved: the host member state (where the emission reduction would take place), the guest member state (the one claiming the emission reductions) and a third party acting as a broker.

We suggest that the third party in this case, working as the facilitator for investments between member states, should be the European Investment Bank (EIB).

The EIB has recently shown its commitment to move away from funding fossil fuel projects.<sup>9</sup> Additionally, the EIB has started to call itself “the EU’s climate bank”. This sends a clear signal of the role the EIB sees for itself in decarbonising Europe’s economy. The implementation and management of the European Project Mechanism would be the perfect example of its new ambitions.

The EIB could create a platform of potential projects, based on expressions of interest submitted by host member states, where the emission-reduction project would take place. Regional or local government, and also the private sector, could also submit project ideas. The projects would come at a price per tonne of CO<sub>2</sub>, based on project costs. A platform could also be created, where the host member state could present potential projects to guest member states. Only sectors under the CAR would participate in the EPM.

The funding for the project would come from the host member state, from the guest member state receiving the emission reductions and loans from the EIB itself. The proportions to be contributed by each party could be subject to the specific arrangement. Getting the EIB on board could unleash more emission reductions that would have not taken place otherwise. At the same time, the guest member state would receive more emission reductions at a lower price, while the host member states would benefit from all the co-benefits of reducing GHG emissions, such as improved air quality, energy independence, quality of life or modernisation of its economy.

The EPM would not be a project mechanism in the style of the Clean Development Mechanism (CDM) of the United Nations Framework Convention on Climate Change (UNFCCC), which includes the concept of additionality.<sup>1</sup> The units transferred from the host to the guest member state would be based on a baseline situation, but additionality would not have to be proven, given it would be a closed system. Additionally, the scope of the project would be limited to direct emissions (scope 1), given that other emissions are covered by different EU climate instruments. Going for a whole life cycle analysis approach, including scope 2 (emissions associated to power production) and 3 (embedded emissions in the goods) would make the EPM overly complicated, without adding any additional value.

Therefore, the EPM would be considerably simpler from a methodological point of view. If the foreseen emission reductions were originally overestimated in the project documentation, it would be the responsibility of the host country to achieve the CAR targets anyway. So overall, it would not have a negative impact on the EU overall reduction target achievement.

### **An example in the transport sector**

A host member state has an old fleet of diesel buses in its capital city. It would like to replace them with electric buses, but they don't have the funding nor the know-how to do so. Therefore, it asks for help from the EIB.

The EIB would know of potential guest member states with experience on using electric buses while looking for emission reductions to achieve its own targets. The platform could also be used. The guest member state, together with the EIB and the host member state, would agree to finance the project (i.e. a combination of direct co-financing and loans).

In exchange, the host member state would transfer an amount of CAR units (Annual Emission Allocations - AEAs) to the guest member state, approximately equivalent to the emission reductions expected from changing the bus fleet.

When comparing the baseline (diesel buses) and the project (electric ones), only direct emissions would be considered. Both emissions from producing the diesel and the electricity are covered by

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<sup>1</sup> Additionality refers to the concept of what would have happened in the absence of the project. In the case of the CDM, it consisted in proving that the emission reductions would have not taken place otherwise. However, there are serious questions about how additional CDM projects are. An analysis for the European Commission proved that 85% of CDM projects have a low likelihood of being additional. Öko Institut. (2016). How additional is the Clean Development Mechanism? Analysis of the application of current tools and proposed alternatives. Retrieved from: [https://ec.europa.eu/clima/sites/clima/files/ets/docs/clean\\_dev\\_mechanism\\_en.pdf](https://ec.europa.eu/clima/sites/clima/files/ets/docs/clean_dev_mechanism_en.pdf)

the EU ETS, outside the scope of the project. Even if producing the electric buses also incur emissions somewhere (either in Europe or abroad), those are offset during the use of the bus, and more importantly creating the right framework to decarbonise in the long term.

#### **4. Why moving CAR sectors into the ETS would not work**

Some might say that if a project mechanism is going to be created for CAR sectors, it would be simpler to expand the ETS into CAR sectors. However, there are several reasons why the current climate architecture (ETS and CAR sectors separately) should be kept.

First of all, actors in each system are very different: the ETS covers companies, while the CAR covers emissions mostly produced by citizens. While companies are more economically rational actors, citizens work differently. For instance, companies might factor in their investment decisions current and future carbon prices, while citizens only factor in to some extent current fuel prices, and more emotional decisions take place.

Secondly, there are many market barriers that are not addressed through pricing instruments (e.g. landlord vs tenant dilemma or higher up-front cost of EVs vs. ICE even if lower total cost of ownership). At current prices, or even at maximum prices, given the (low) elasticity of sectors such as road transport, the impact of increasing the price is very limited on reducing demand (few cents extra per liter, in the case of diesel or petrol). For instance, if someone owns a house and needs to commute by car, in the absence of public transport the individual doesn't have an alternative. This limited, theoretical demand reduction would only apply if national governments would not decide to decrease fuel taxes to offset the ETS impact. It would also risk increasing energy poverty, particularly in heating.

In most CAR sectors, the abatement cost is higher than in, for example the power sector. However, in order to achieve climate targets, the transition cannot be postponed until carbon prices would be high enough. For example, renovating the building stock of the car fleet takes several decades.

Additionally, national governments have many tools at their disposal to reduce emissions in CAR sectors, like promoting modal shift, tackling demand through road charging or fuel taxes, or promoting zero-emission technologies beyond EU standards. The same applies to emissions from the building sector.

For all the reasons above, it is better to keep the current architecture, keeping member states accountable to achieve CAR 2030 targets, but while creating a European Project Mechanism that would enhance action in these sectors.

## 5. Conclusion and Policy Recommendation

The European Project Mechanism has the potential to increase the cost-effectiveness of reducing emissions in sectors included in the CAR, while creating the right political framework to increase CAR targets in the context of the Commission's review of 2030 climate targets.

The European Commission should, in its upcoming proposal for a European Climate Law, include the commitment to create an EPM for sectors under the Climate Action Regulation.

### Further information

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### Endnotes

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- <sup>3</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32003L0087>
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