EU Emission Trading System Reform

The EU's "Fit for 55" package conference

SCB & VlaVER – 9 March 2023

Introduction

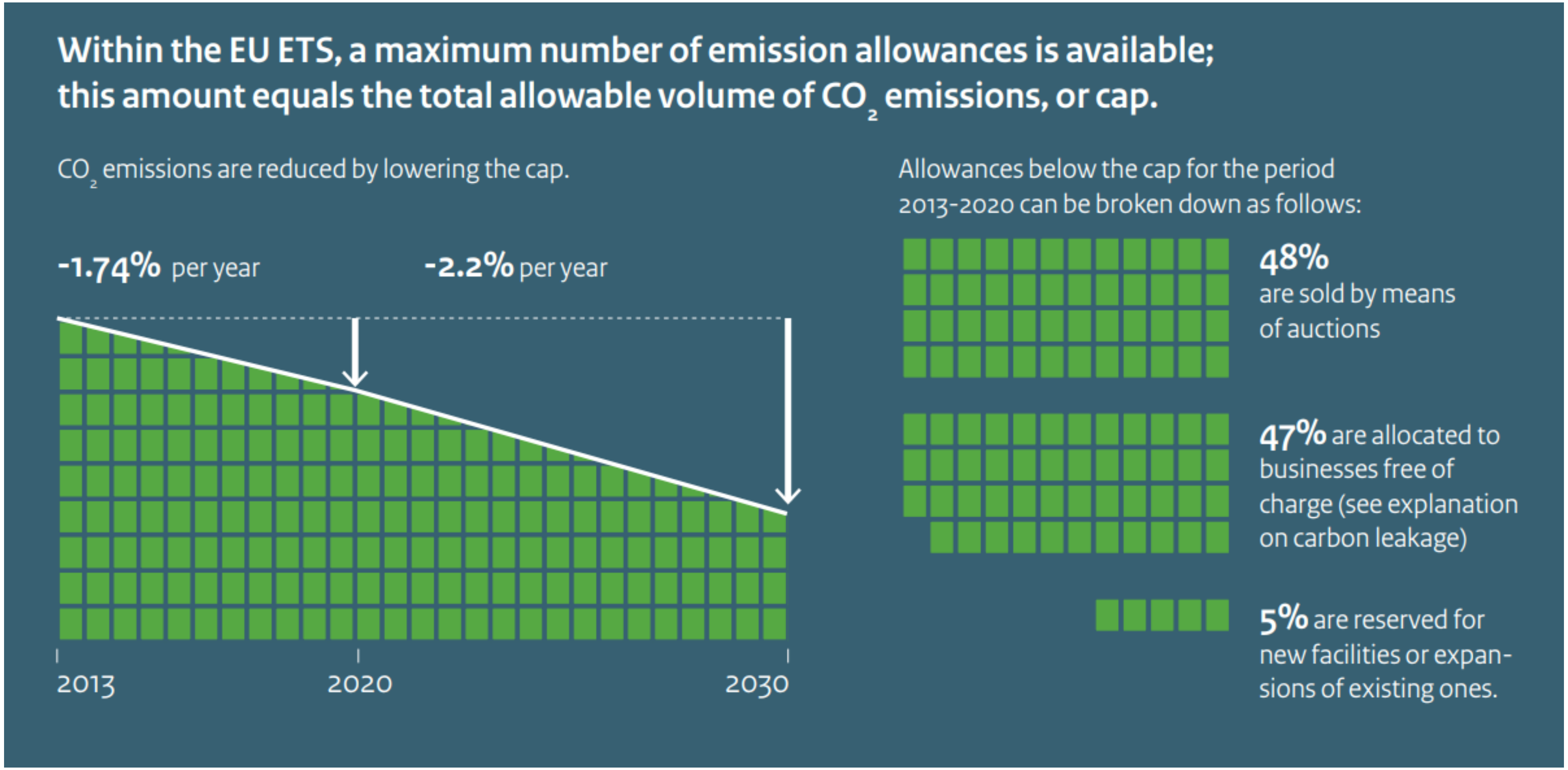
Introduction

How it works (Directive 2003/87/EC)

- Idea:
  - Put a price on the right to emit 1 tonne of CO2 (= allowance).
  - Entities covered by ETS must buy and surrender a number of allowances each year, corresponding to their emissions.
- Cap:
  - The number of allowances available per year, is capped => pricing based on supply and demand.
  - The cap decreases.
- Trade:
  - The less a company emits, the less allowances it has to buy => incentive.
  - If the company received more allowances than it needs, it can sell those allowances.
  - Result: reducing emissions where it can be done most cheaply.

Introduction (continued)

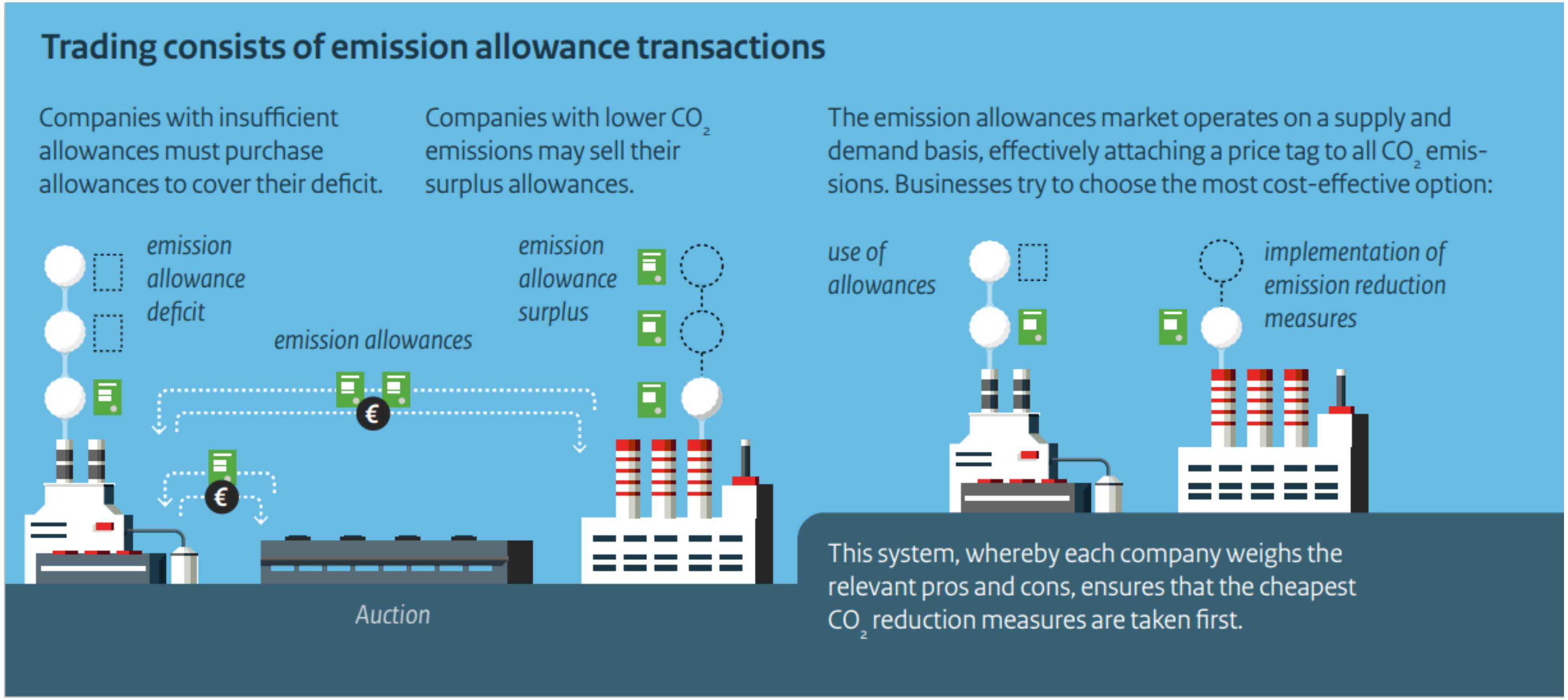
Cap



Source: https://www.emissionsauthority.nl/documents/publications/2015/12/10/infographic-how-does-the-eu-ets-work

Introduction (continued)

Trade



Source: https://www.emissionsauthority.nl/documents/publications/2015/12/10/infographic-how-does-the-eu-ets-work

Introduction (continued)

How it works

- Where to buy allowances:
  - Buy them at auction (European Energy Exchange).
  - Receive them for free (risk carbon leakage).
  - Buy them on the secondary market:
- Revenues
  - Auction revenues from the existing ETS go mainly to Member States' budgets
  - Under the existing EU ETS, Member States are required to spend at least half of their auction revenues to support greenhouse gas emissions reductions, to deploy renewables and CCS, and to improve energy efficiency and district heating.

Introduction (continued)

How it works

- Geographical coverage:
  - All EU countries
  - + Iceland, Liechtenstein and Norway (EEA-EFTA states)
- Sector coverage
  - Depends on the type of GHG (CO_2, N_2O, PFCs).
  - CO_2:
    - electricity and heat generation,
    - energy-intensive industry sectors (incl. oil refineries, steel works, and production of metals);
    - aviation within the European Economic Area

Introduction (continued)

Price

EUA Futures
07/03/2023

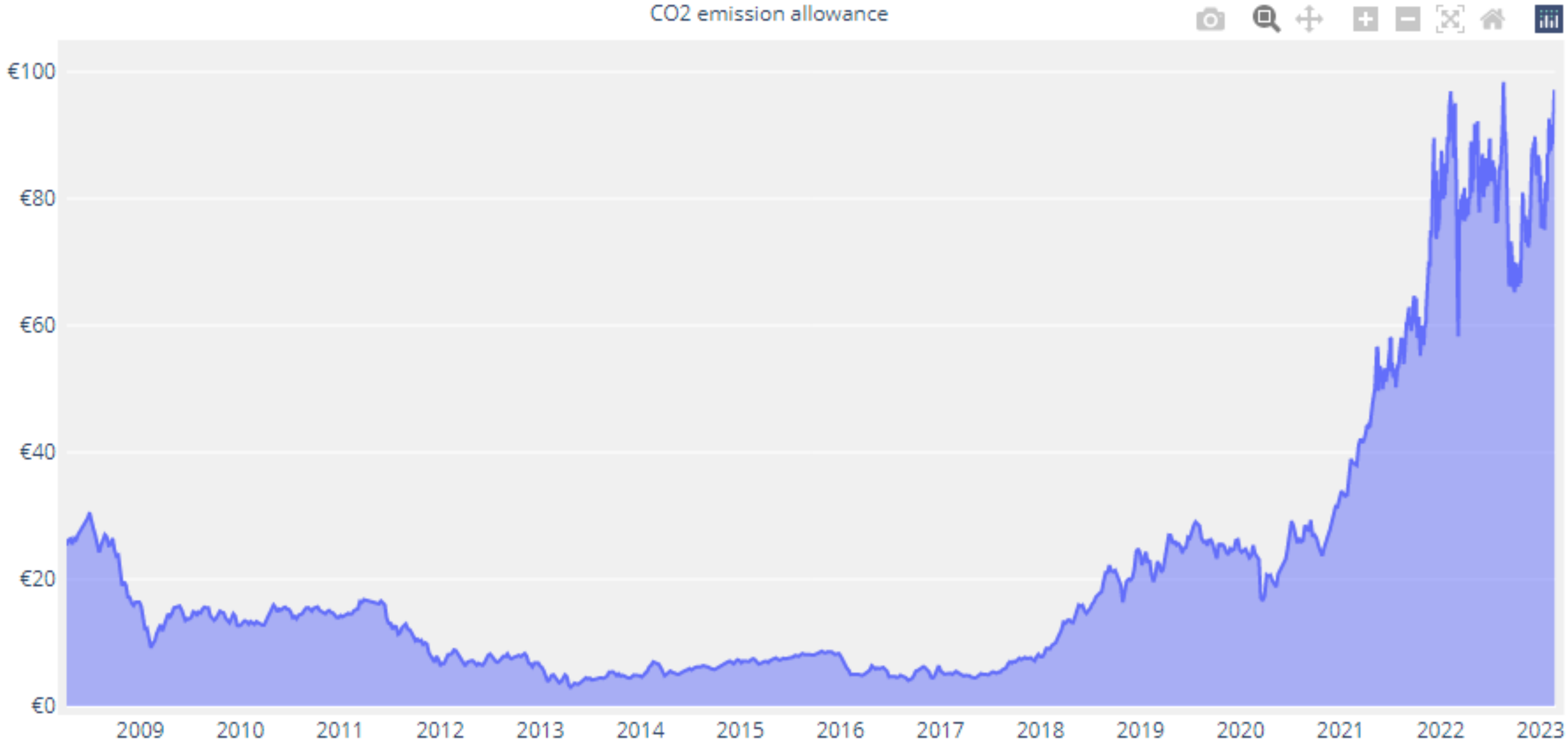
€92.95

DEC 23
€92.95

DEC 24
€97.94

DEC 25
€102.85

Source



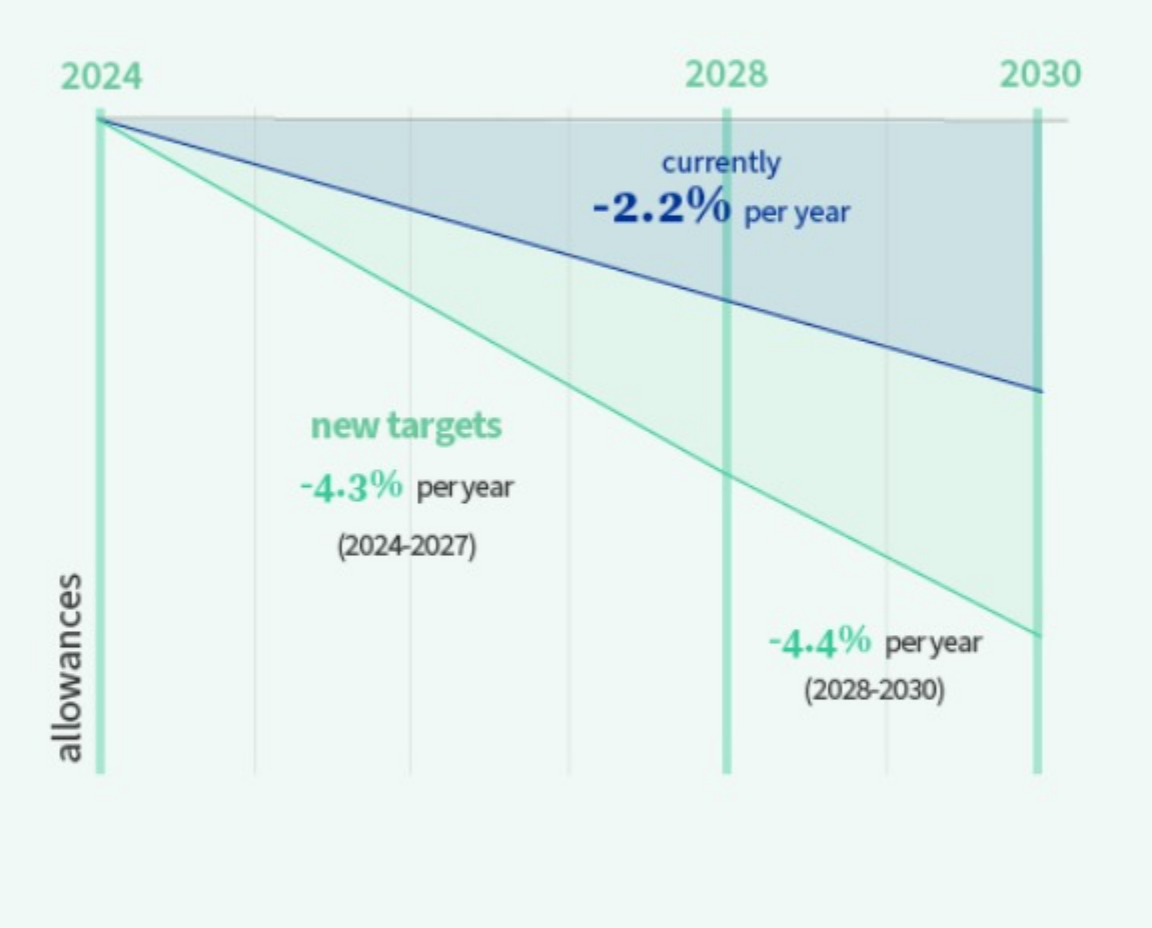
Source: https://sandbag.be

Reform 1: more ambitious target

Target

Overall ambition of emissions reductions by 2030 in the sectors covered by the EU ETS

- Target
  - Current: - 43%
  - New : **- 62%**
  - = emissions for sectors covered by EU ETS1 with 2005 as base year
- Reduction rate:
  - Current: - 2,2% per year
  - New:
    - 4,3 % per year from 2024 to 2027
    - 4,4% from 2028 to 2030
  - Additional one-off reductions of allowances in 2024 and 2026



Source: [Fit for 55: reform of the EU emissions trading system - Consilium (europa.eu)]

Reform 2: Broaden coverage

Broaden coverage

Maritime shipping emissions

- Gradual introduction of obligations for shipping companies to surrender allowances:
  - 40% for verified emissions from 2024,
  - 70% for 2025; and
  - 100% for 2026
- Big offshore vessels of 5000 gross tonnage and above:
  - included in the MRV regulation from 2025; and
  - Included in the EU ETS from 2027.
- General cargo vessels and off-shore vessels between 400-5 000 gross tonnage:
  - included in the MRV regulation from 2025;
  - their inclusion in EU ETS will be reviewed in 2026.
- Non-CO2 emissions (methane and N2O) will be included in the MRV regulation from 2024 and in the EU ETS from 2026.

Broaden coverage

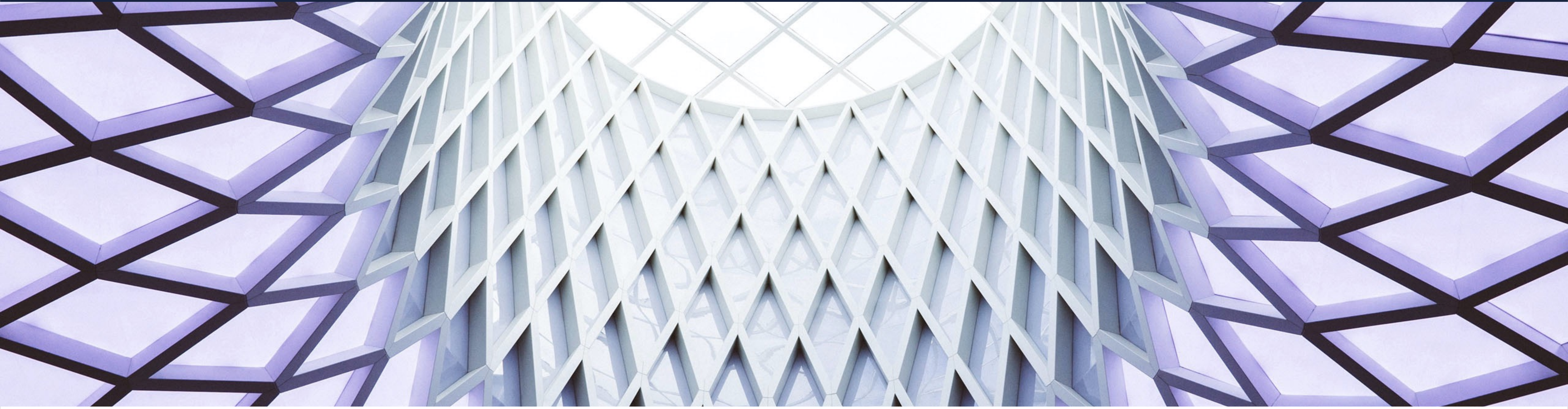
Municipal waste incineration

- Will now fall under EU ETS as from 2028 onwards, with possible derogations until 2030 and subject to an EU impact assessment to be completed by 1 January 2026 indicating that inclusion of this sector in EU ETS is feasible
- Monitoring and verification of emissions of such installations required as from 2024

Carbon capture and removal

- Now expressly states that there is no obligation to surrender allowances arises for emissions "*considered to have been captured and utilised to become permanently chemically bound in a product so that they do not enter the atmosphere under normal use, including any normal activity taking place after the end of life of the product*"
  - Delegated act to be adopted by the EC
- Separate EU GD proposal for a Regulation to establish a Union certification framework for carbon removals (Nov 2022): precursor for a future land sector carbon removal trading system?

Reform 3: Phase-out free allowances



Phase out of free allowances

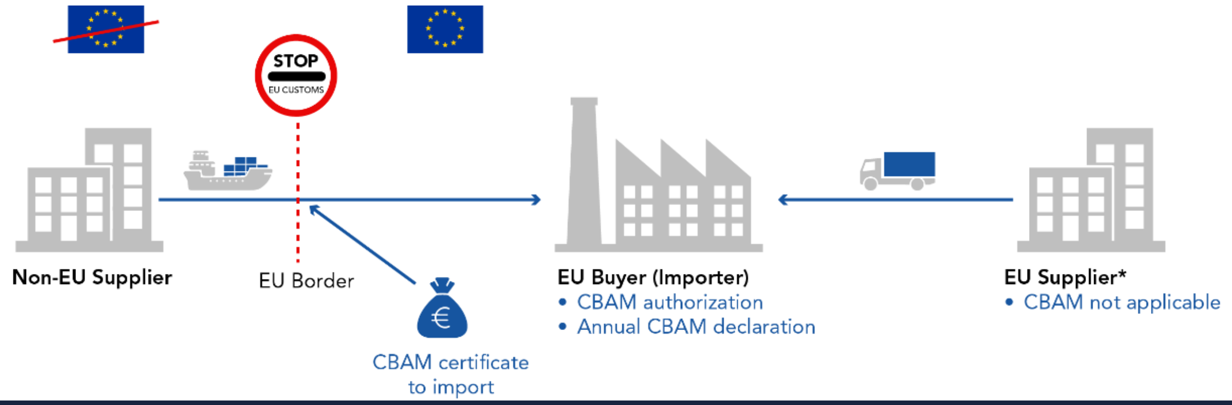
General

- Rationale of free allowances: avoid carbon leakage (especially in carbon intensive sectors)
- Lower incentive to reduce emissions ➔ new paradigm: moving from free allocation to CBAM
- Phase out of free allowances in the following sectors: cement, aluminium, fertilisers, electric energy production, hydrogen, iron and steel (+ certain precursors and downstream products)
- Gradual phase-out over a period of nine years, from 2026 to 2034
  - Coupled with phase-in rhythm under CBAM: starting in 2026 and fully phased in by 2034.
  - CBAM will then only apply to proportion of importer's emissions that is not covered by free allowances domestically
- Start at a slow pace and accelerate towards the end of the period
  - 2026: 2.5%; 2027: 5%; 2028: 10%; 2029: 22.5%; 2030: 48.5%; 2031: 61%; 2032: 73.5%; 2033: 86%; 2034: 100%
- To support decarbonization of these sectors, funding from the Innovation Fund will be made available
- Link with State aid for indirect emissions costs

Phase out of free allowances (continued)

CBAM

- Importers of the goods will have to, either individually or through a representative, register with national authorities where they can also buy CBAM certificates
- In order to import goods covered under the CBAM into the EU, they must declare by 31 May each year the quantity of goods and the embedded emissions in those goods imported into the EU in the preceding year
- At the same time, they must surrender the CBAM certificates they have purchased in advance from the authorities
- Result: ensure equal treatment for products made in the EU and imports from elsewhere



Phase out of free allowances (continued)

Export-related carbon leakage risk

- No free allowances provided for (yet)
- For goods subject to CBAM the EC is to assess by 2025 whether there is an export carbon leakage risk
- If such risk is identified the EC is to present a WTO-compliant (?) legislative proposal to address that risk

Reform 4: Creation of an additional ETS

Creation of an additional ETS

- A new ETS ("ETS2"), separate from the one that already exists, going beyond large installations
- Coverage: the distribution of fuels which are used for combustion in the sectors of
  - buildings; and
  - road transport; as well as
  - certain other sectors (e.g. manufacturing / process heat at non-ETS installations)
- Agriculture and fisheries sector exempted
- Start: 2027 (possible postponement until 2028 with high energy prices)
- No free allocation, only auctioning (limited risk of carbon leakage)
- Price stability mechanism: price ceiling of 45 EUR until 2030; thereafter additional ETS2 allowances released when price >45 million EUR
- Possibility for MSs to exempt suppliers until December 2030, if they are subject to a carbon tax nationally at an equivalent or higher level than the ETS2 allowances auction price
- A possible merger of the two ETS systems will be assessed only after a few years of the functioning of the new emission trading system

Reform 5: Funding

Funding

- New fund: Social Climate Fund (87 billion EUR)
  - The “political counterpart” of ETS2 – avoidance of *gilets jaunes* protests
    - E.g. expected increase in pump fuel prices: 10.5 cents/l for petrol; 12 cents/l for diesel (Potsdam Institute for Climate Research)
    - Also price increases for heating fuels such as gas, heating oil and coal
  - Fund will be part of the EU budget and fed for 75% from ETS2 auction revenues and for 25% by funding from the Member States
  - The fund will be used by MSs (upon submission of a ‘social climate plan’) to finance measures and investments to address the impact of carbon pricing on vulnerable citizens and micro-enterprises
  - Funds disbursed in 2026, one year before ETS2 takes effect

Funding (continued)

- Modernisation fund
  - Its volume will be increased through the auctioning of an additional 2.5% of the cap for which 90% must be used to support priority investments.
  - Only applies to undertakings from certain eligible (lower-income) EU Member States

- Innovation fund
  - Dedicated calls to support decarbonisation of the maritime sector.
  - Support for decarbonisation of sectors subject to carbon leakage (both vis-à-vis imports and for export-related carbon leakage)
  - Continuation of crucial funding for infrastructure for decarbonisation of industry and energy sectors, also under RePowerEU (e.g. CCS projects in Belgium, H2 projects,…)
  - New specific regime for “contracts for difference” and “carbon contracts for difference”

Concluding remarks and Q&A

Thank you!

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