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The Review of the EU ETS

OVERVIEW OF THE EUROPEAN COMMISSION PROPOSAL, 14 JULY 2021

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Introduction

As part of its "Fit for 55" climate and energy package, the European Commission issued on 14 July 2021 a proposal for the review of the EU ETS. The proposal is designed to make the ETS able to deliver 61% GHG emissions reduction by 2030, in line with an at least overall 55% target. This target marks a significant quantitative leap in ambition with respect to the current scenario, where ETS sectors are expected to deliver a 43% reduction in emissions. The review of the ETS involves an increase in the level of ambition and a number of significant changes that will affect the functioning of the EU carbon market. The ETS Review coincides with the first review of the Market Stability Reserve, which the Commission is required to conduct "within three years of the start of the operation of the reserve".

Core elements	Proposed design in EC proposal
Ambition	- 61% Emissions reduction target for ETS sectors - 4.2% LRF and rebase to ensure that "the new LRF has the same effect as if it would have applied from 2021", no matter when the proposal enters into force
Free Allocation	- Maximum update rate of benchmarks to 2.5% as of 2026, up from current 1.6% - Conditionality on implementation of measures recommended in energy audits - Free allocation for CBAM sectors phased out by 2035
MSR	- The 24% intake rate maintained until 2030 - Buffer intake to avoid threshold effect when TNAC between 833 and 1096 million - Allowances in the MSR above the fixed level of 400 million will be cancelled - TNAC will include aviation emissions
Use of ETS Revenues	- 100% ETS revenues must be used for climate-related purposes
Modernisation Fund	- An additional 2.5% of the cap is auctioned to fund the transition in MS with below average GDP per capita in 2016-18 through the Modernisation Fund - The fund cannot finance investment in any type of fossil fuel
Innovation Fund	- 200 mln allowances are added to the Fund, 150 from the transport and buildings ETS - The scope of the fund includes support of project via carbon contracts for difference
ETS Extension to Maritime Transport	- The scope of the ETS is extended to include maritime transport - The ETS covers all emissions from intra-EU voyages, 50% from extra-EU voyages and at berth in an EU port - As of 2026 shipping companies will have to surrender 100% of their emissions
New ETS for Road Transport and Buildings	- The cap of the new ETS will be set from 2026, alongside a LRF to reach 45% emissions by 2030 compared to 2005 - A price-based cost-containment mechanism will avoid price spikes - A new and separate MSR for the two sectors will start operating in 2027

Main elements of the ETS proposal

Ambition:

The Commission proposes a 61% emissions reduction by 2030 for sectors covered by the ETS compared to 2005. This higher target will be achieved through a combination of a higher Linear Reduction Factor and a one-off reduction of the cap. Both will be implemented the year following the entry into force of the Directive. The linear reduction factor is changed to 4.2%, up from the current 2.2%. The rebase of the cap will be calculated so that "the new linear reduction factor has the same effect as if it would have applied from 2021". This means the longer it will take for the entry into force, the bigger the rebase will be and could have a bullish impact on the market. This design also ensures the environmental delivery of the ETS, regardless of when the directive will enter into force.

Free Allocation:

To reduce the possibility of triggering the cross-sectoral correction factor (CSCF), the Commission proposes to increase the maximum update rate of benchmarks to 2.5% as of 2026, up from current 1.6%. The proposal features no changes to the minimum 0.2% benchmark.

Free Allocation is made conditional on installations' decarbonisation efforts. Installations covered by energy audit obligations will be required to implement report recommendation or other measures leading to equivalent GHG reduction, otherwise free allocation will be reduced by 25%. The proposal specifies that the requirements hold for investments with a pay-back period no longer than 5 years.

Sectors covered by CBAM - steel, aluminum, cement, fertilizers, and electricity – would have a 10-years transition period to adapt to the new regime before free allocation is fully phased-out. Free allocation for this sectors would decline by 10% yearly, starting in 2026 and would be zero by 2035.

Use of Revenues

The Commission proposes that member states must use 100% auction revenues for climate-related purposes, including low-income households' sustainable renovation. This would be a significant increase from both the current requirement to spend at least 50% on these purposes, and the 78% average expenditure that countries have recorded since 2013.

Modernisation Fund

The Commission proposes that an additional 2.5% of the cap is auctioned to fund the transition in MSs with GDP per capita below 65% of the EU average in 2016-18 through the Modernisation Fund.

At the same time, however, the Commission intends to prohibit investments in any fossil fuel trough Modernisation Fund resources – instead of only solid fossil fuels as it is currently stipulated. This means, for example, that it would no longer be possible to use Modernisation Fund resources to finance investments in coal-to-gas fuel switching projects.

Innovation Fund

Under the Commission proposal, the size of the Innovation Fund would also increase. 50 mln allowances are added to the Fund. Additional 150 mln allowances would come from the separate EU

ETS for road transport and buildings. Moreover, the proposal also establishes that free allocation no longer provided to CBAM sectors will be auctioned, with revenue accruing to the Innovation Fund. The scope of the Innovation Fund would also be extended, to allow for the support of project via carbon contracts for difference.

Market Stability Reserve

The 24% intake rate would be maintained until 2030. Large MSR intakes might trigger EUAs price spikes and amplify discontinuities linked to MSR intakes when the TNAC is close to the 833 mln threshold[1]. This risk is mitigated by the introduction of the so-called *buffer intake rate*. Under the proposal, a buffer MSR intake is triggered when TNAC is between 833 and 1096 million. In that case, the intake will be equal to the difference between the TNAC and the 833 thresholds. When TNAC > 1096, the normal 24% intake rate would apply, at least until 2030. This adjustment is in line with what the argument already advanced by ERCST that MSR intakes would better reflect market fundamentals if applied "only to the number of allowances above a determined threshold"[2].

Under current rules, as of 2023 allowances in the MSR above the previous year auction volumes will be invalidated. In the proposal, the commission suggests limiting the number of allowances in the MSR at a fixed level of 400 million. This change would make invalidation more predictable but would still make it possible to change the cap through the MSR, a task that lies outside the reserve's original purpose. In the proposal, TNAC calculation will include also aviation emissions. As aviation demand for allowances is slated to increase, keep excluding it from TNAC calculations would have prevented the MSR from acting based on market realities.

ETS Extension to Maritime Transport

The scope of the ETS is extended to include maritime transport. The same rules on auctioning, transfer, surrender and cancellation of allowances, penalties and registries would apply to emissions from intra-EU voyages and to half of the emissions from extra-EU voyages and at berth in an EU port. Surrender obligations are gradually phased in between 2021-2025. As of 2026 shipping companies will have to surrender 100% of their verified emissions. Shipowners will have to surrender units for 20% of verified emissions reported for 2023, 45% of emissions for 2024, 70% for 2025, and 100% by 2026. Non-surrendered allowances during the phase-in period would be cancelled.

New ETS for Road Transport and Buildings

A separate ETS – without free allocated allowances and with its own cap, LRF and MSR will be created for road transport and buildings in 2025. Compliance obligations would start in 2026. The cap of the new ETS will be set from 2026, alongside a linear reduction factor in line with a 45% emissions reduction in these sectors by 2030 compared to 2005.

The proposal provides for a cost containment mechanism to address the low-price elasticity of these sectors and mitigate the risk of potentially very high EUA prices. Under the mechanism, the MSR for this separate ETS will release additional allowances – 50 mln or 150 mln - based on the average price level of allowances over a three-month period.

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[1] ERCST, "The Review of the Market Stability Reserve", April 2021.
[2] ERCST, "The Review of the Market Stability Reserve", op. cit.

The MSR will start operating in September 2027 and would be initially endowed with 600 million allowances. The MSR for these two sectors will absorb 100 million allowances if TNAC >440 million while would release 100 mln permits should TNAC be < 210 million. The Commission also proposes that allowances to the transport and buildings sector would be front-loaded, with auctions in 2026 representing 130% of the annual volume. This additional volume would be deducted from auctions to be held in 2028-30.

EU will set up a Climate Action Social Fund to "address social impacts of the extension of emissions trading to road transport and buildings". The fund will be financed by the EU budget, using an amount equivalent to 25% of the expected revenues of emissions trading for building and road transport fuels.

Conclusions

The Commission proposal constitutes a delicate balancing act between different, and sometimes hardly reconcilable, demands and expectations. On the one hand, the ETS is acknowledged to be the most effective tool at the EU's disposal to trigger cost-effective emissions abatement across the sectors of the economy. On the other hand, the proposal tries to incorporate the concerns of those who stressed the impact that high carbon prices could have on both the competitiveness of the EU economy and on more vulnerable households.