Revision of the EU Emissions Trading System – a progress report

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Introduction

In July 2021 the European Commission set out plans for revising the European Union's Emissions Trading System (ETS) as part of the so-called Fit for 55 package, its broad strategy for reducing greenhouse gas emissions by at least 55 percent by 2030 compared to 1990 levels. The Commission's proposal aimed to deliver a larger reduction in greenhouse gases, introduce coverage of the maritime sector, create a separate so-called ETS II for road transport and buildings, and increase funding for less-wealthy EU member states to modernise their energy sectors. Following intense negotiations, the European Parliament approved an amended version of the Commission's ETS revision plan on 22 June. One week later the Council of the EU also reached an agreement on a general approach to the plan.

The three Brussels institutions—Council, Parliament, and Commission—will now seek to agree a text of the ETS revision plan. The early indications suggest the negotiations will be technical and difficult and could last several months. The Council and Parliament are at odds on a range of key issues, including the level of ambition, the timeline for cutting emissions in sectors covered by the ETS, the free allowances' phase out period and the implementation date of the planned ETS II.

This Dods EU Political Intelligence report provides a guide to the European Commission's plan to revise the ETS, including the original proposal, the positions of the European Parliament and Council of the EU, and the outlook at the start of trilogue negotiations.

Origins of the ETS revision proposal

The EU Emissions Trading System was the first large-scale greenhouse gas (GHG) emissions trading scheme in the world. Based on the cap-and-trade principle, it aims to reduce emissions by setting a gradually lower annual limit on the total amount of GHG participating installations can produce per year and enabling the companies to buy and sell emissions allowances to encourage them to use more sustainable methods of production.

Introduced in 2005, the ETS operates in every EU country plus Iceland, Liechtenstein, and Norway (EEA-EFTA states), and covers about 40 percent of the bloc's GHG emissions. The EU says the market-based system has helped reduce emissions by some 42.8 percent in the areas it covers, which include about 10,000 installations in the power sector and industry, as well as airlines operating between participating countries. ETS emissions posted their sharpest annual record drop on record in 2019 as economies were hit by the Covid-19 pandemic, but EU countries expect emissions to drop at a slower pace in coming years. Every year, participating installations must surrender enough allowances to cover their emissions or face fines. If an installation reduces its emissions, it can keep the spare allowances to cover its future needs or sell them to another installation that needs them.

The ETS covers the following sectors and gases, focusing on emissions that can be measured, reported, and verified with a high level of accuracy:

- Carbon dioxide (CO_2) from
    - electricity and heat generation,

    - energy-intensive industry sectors including oil refineries, steel works, and production of iron, aluminium, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids, and bulk organic chemicals,
    - commercial aviation within the European Economic Area.
- nitrous oxide (N_2O) from production of nitric, adipic and glyoxylic acids and glyoxal.
- perfluorocarbons (PFCs) from production of aluminium.

The ETS is reinforced by the Market Stability Reserve (MSR) which aims to align the supply of emissions allowances in the ETS more closely with demand by reducing or increasing the total number of allowances in circulation to stabilise the market. It began operating in January 2019 and is the product of various development phases of the EU ETS: 2005-2008, 2008-2012, 2013-2020 and 2021-2030.

The MSR began by using the 900 million allowances that were backloaded in 2014-2016 and unallocated allowances. The reserve operates entirely according to pre-defined rules that leave no discretion to the Commission or member states. Each year, the Commission publishes by 15 May the total number of allowances in circulation. This serves as the exclusive indicator on whether allowances will be placed in the reserve, and if so how many; or whether allowances will be released from the reserve. For the 2019-2023 period, the percentage of the total number of allowances in circulation determining the number of allowances put in the reserve if the threshold of 833 million allowances is exceeded is temporarily doubled to 24 percent.

The European Commission's key ETS revision proposals include:

- Increasing the reduction of greenhouse gas emissions to -61 percent in sectors covered by the ETS, compared to 2005.
- Include the maritime sector within the existing ETS from 2023, with a gradual phasing-in period where shipping companies would only have to surrender allowances for a portion of their verified emissions, gradually rising to 100 percent over four years.
- The creation of a separate but adjacent Emissions Trading System (ETS II) for road transport and buildings.
- Increase the percentage of ETS revenues allocated to the EU Modernisation Fund to help the poorest EU Member States modernise their energy sector

The Commission has also put forward a proposal to amend the MSR, in line with the European Climate Law, which would keep the number of allowances placed each year in the reserve at 24 percent after 2023 and that the minimum number of allowances to be placed in the reserve at 200 million. It aims to ensure the MSR can continue tackling structural supply-demand imbalances following changes to the EU ETS and factors such as COVID-19 or national plans to change the energy mix such as coal phase-outs.

As part of REPowerEU, a €300bn strategy to reduce the EU's dependence on Russian fossil fuels and speed up the green transition, the European Commission has also set out plans to increase the Recovery and Resilience Facility's (RFF) fund with €20bn in grants from the sale of EU ETS allowances held in the MSR, to be auctioned in a way that does not disrupt the market. Some stakeholders have criticized this proposal, claiming that this will in fact increase the EU's dependence on imported fossil fuels through re-investing them into carbon and methane emitting gas (CAN Europe).

European Parliament response

The rapporteur on the Revision of the EU's ETS is MEP Peter Liese (EPP, DE).

The Parliament's Committee on Environment, Public Health and Food Safety agreed and approved a report on the revision of the EU ETS on 17 May, with 62 votes in favour, 20 against and 5 abstentions. However, MEPs rejected it at a Plenary session on 8 June--with 340 votes against, 265 in favour and 34 abstentions—following fierce debate between the political groups, especially the S&D and EPP. The EPP had advocated for placing a carbon price on emissions from transport and buildings, whereas the S&D expressed concerns on how that would affect consumers' energy bills and demanded that the EU's Social Climate Fund be expanded to compensate the poorest households. The S&D and the Greens/EFA also wanted a more ambitious ETS which would lead to greater emissions reductions, while the EPP said the Commission proposal was ambitious enough given the geopolitical situation.

The EPP, S&D and Renew Europe eventually reached a compromise agreement on the ETS revision and the associated Carbon Border Adjustment Mechanism (CBAM) and Social Climate Fund reports. That paved the way for them to adopt an amended report in Plenary on 22 June with 439 in favour, 157 against and 32 abstentions. The main elements of the adopted report include:

- An increase in the reduction of emissions in sectors covered by the ETS from -61 percent to -63 percent. To achieve this, Parliament calls for further one-off cuts to the EU-wide quantity of allowances in circulation, in combination with an increase in the annual reduction of allowances to 4.4 percent until the end of 2025, rising to 4.5 percent from 2026 and to 4.6 percent from 2029.
- The introduction of a bonus-malus system to incentivise best performers and reward the most efficient installations in a sector with additional free allowances. Those who fail to implement the recommendations made in the energy audits, do not certify their energy systems or do not establish a decarbonisation plan for their installations, and lose some or even all of their free allowances.
- ETS will be extended to maritime transport. MEPs want to cover 100 percent of emissions from intra-European routes as of 2024 and 50 percent of emissions from extra-European routes to and from the EU as of 2024 until the end of 2026. From 2027, emissions from all trips should be covered 100 percent with possible derogations for non-EU countries where coverage could be reduced to 50 percent subject to certain conditions.
- The inclusion of municipal waste incineration from 2026.
- The free allowances in the ETS sectors covered by CBAM should be phased out from 2027 and disappear by 2032 when Parliament wants the mechanism to be fully implemented - three years earlier than planned by the Commission. Free allowances should be reduced to 93 percent in 2027, 84 percent in 2028, 69 percent in 2029, 50 percent in 2030, 25 percent in 2031 and zero in 2032.
- The creation of a new emissions trading system (ETS II) for fuel distribution for commercial road transport and buildings on 1 January 2024 - one year earlier than proposed by the Commission.
    - To prevent citizens from having to bear additional energy costs, residential buildings and private transport should not be included in the new ETS before

    - 2029 and only subject to a thorough assessment by the Commission followed by a new legislative proposal to be agreed upon by Council and Parliament.
    - MEPs voted for revenues from the auctioning of 150 million allowances under the ETS II to be made available for the Social Climate Fund to address the challenges for low-income families.
- Increase the size of the Modernisation and Innovation (to be renamed to Climate Investment Fund) Funds to improve energy efficiency, modernise installations and support innovation.
- Regarding the MSR, Parliament appointed MEP Cyrus Engerer (S&D, MT) as the rapporteur. On 5 April, 2022, the Plenary voted to extend the temporary adjustments in the MSR until the end 2030, so that after 2023 at least 24 percent of the market surplus should be put in the reserve. However, as Parliament wants to set to 200 million the minimum number of allowances which can be withdrawn in a given period, there will only be further withdrawals to the reserve, when the surplus of allowances is above 833 million. Without the MSR, MEPs believe there would be fewer incentives for industries to reduce GHG emissions. The adopted text on the MSR is here.

ETS Report: Plenary, ENVI

Opinions: BUDG, DEVE, ITRE, TRAN

Council of the EU

The Council of the EU reached a general approach on 28 June, during the Environment Council meeting. EU Ministers agreed the following:

- Keeping the overall ambition of 61 percent of emissions reductions by 2030 in the sectors covered by the EU ETS, as proposed the Commission.
- A one-off reduction of the overall emissions ceiling by 117 million allowances ("re-basing") and to the increase in the annual reduction rate of the cap by 4.2 percent per year ("linear reduction factor").
- Strengthening the MSR, by prolonging, beyond 2023, the increased annual intake rate of allowances (24 percent) and setting a threshold of 400 million allowances above which those placed in the reserve were no longer valid.
- Regarding sectors covered by CBAM, the Council endorsed the proposal to end free allowances for the sectors concerned by the CBAM progressively, over a 10-year period between 2026 and 2035. However, the Council accepted a slower reduction at the beginning and an accelerated rate of reduction at the end of this 10-year period.
- Concerning the Modernisation Fund, the Council maintained the increase in its volume through the auctioning of an additional 2.5 percent of the ceiling, the increase in the share of priority investments to 80 percent and the addition of new eligible sectors, as proposed by the Commission. The Council decided to extend the list of member states benefiting from the Modernisation Fund. Natural gas projects will in principle not be eligible.
- To include maritime shipping emissions within the scope of the EU ETS. The general approach accepts the Commission proposal on the gradual introduction of obligations for shipping companies to surrender allowances. To alleviate the burden on member states

heavily dependent on maritime transport which will be the most affected, the Council agreed to redistribute 3.5 percent of the ceiling of the auctioned allowances to those member states. In addition, the general approach considers geographical specificities and proposes transitional measures for small islands, winter navigation and journeys relating to public service obligations
- The Council agreed to create a new, separate emissions trading system for the buildings and road transport sectors (ETS II). The new system will apply to distributors that supply fuels for consumption in the buildings and road transport sectors. However, the start of the auctioning and surrender obligations will be delayed by one year compared to the Commission proposal (auctioning of allowances from 2027 onwards and surrender from 2028 onwards).

General Approach

Next Steps

On July 11 the European Parliament's Committee on Environment, Public Health and Food Safety confirmed that representatives of the Council of the EU, the European Commission and the Parliament had started so-called trilogue discussions on the proposed Revision of the EU ETS.

Negotiations are expected to be highly technical and difficult in the coming months. The Council and Parliament have significant differences on the level of ambition, the proposed timeline regarding the reduction of emissions in sectors covered by the ETS. While there is no set deadline, negotiations are expected to take several months. Liese said he aimed to reach an agreement on the important political decisions before the end of the Czech Presidency.

In a statement, Liese highlighted some key dividing lines. The Council wanted to include maritime in 2027 while MEPs favour starting in 2024. The Council also wanted to give free allowances to all industries at risk of carbon leakage, while the Parliament wanted to be more targeted and have additional requirements, for example, carbon neutrality plans and the application of an energy management/audit system to get free allowances, he said. The biggest difference was with the new ETS II for heat and road transport, with the Parliament in favour of including all commercial emissions including process heating, for example, in plastics processing companies and foundries, while the Council and Commission agreed on the Commission proposal's scope, he said.

"While it is important that we agree in principle, on many quite significant points there is a need for quite intensive negotiations," Liese said. "I am convinced that all sides have to move…Only negotiations on equal terms, where both sides are ready to give and take and the result reflects 50 percent of the Council's priorities and 50 percent of the Parliament's priorities in the one or the other way, will help us reach a successful deal."

Once there is an agreement, the text will then require approval by the European Parliament and the Council of the EU, before being formally adopted.

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