– Consultation Response–

Updating the EU Emissions Trading System

Brussels, 4 February 2021 | Europex welcomes the opportunity to participate in the Commission's public consultation to update the EU Emission Trading System (EU ETS) and align it with the increased decarbonisation targets. The EU ETS is Europe's most successful policy to combat climate change and the key carbon pricing instrument to reduce greenhouse gas (GHG) emissions at least cost. To this end, it is important to ensure that this revision strengthens the role of the EU ETS and continues to commit to strong market principles that safeguard the undistorted price signals, efficiency, transparency and liquidity of the emissions market.

In the following, we elaborate on the fundamental principles that should underpin the EU ETS revision, as identified in the public consultation. For our full response, please see Annex I for our answers to the consultation questionnaire.

1. Strengthening the role of the EU ETS while minimising market distortion

The EU ETS must remain Europe's core instrument for reducing greenhouse gas emissions in a cost-effective way. Since its launch in 2005, Europe's volumetric cap-and-trade scheme has successfully delivered on meeting the set targets and reducing emissions. Simultaneously, the EU ETS is vital to promote investments and innovation in low-carbon technologies and to allow for tailored market-based trading and hedging strategies.

A strong carbon market price signal based on the free interplay between supply and demand is at the heart of efficient emissions reductions and a robust EU ETS. To strengthen the carbon price signal and the EU ETS, it is critically important to align the emissions cap with the increased target for 2030, while minimising market distortion. This can be achieved through a combination of the following policy options:

- **Increasing the current EU ETS sectors' contribution in line with the new 2030 target**: Europex supports increasing the EU ETS contribution of the current ETS sectors in a cost-effective manner to align it with the increased 2030 emissions reduction ambition target.

  The EU ETS has delivered on the targets and guaranteed an emissions reduction by about 35% between 2005 and 2019. This stands in stark contrast to emissions reductions in non-ETS sectors, where results are mixed and decarbonisation potential remains untapped. Despite widely diverging targets from a 20% decrease to a 20% increase in emissions, several Member States are unlikely to meet their emissions reduction obligations in non-ETS sectors. While trading of annual emission allocations between Member States can to

some extent balance this afterwards, it is only a less efficient, second-best option with limited transparency and costs which are difficult to predict.

- **Increasing the Linear Reduction Factor (LRF) in a predictable way**: Strengthening the ambition of the EU ETS is first and foremost done by adopting a clear, long-term framework through an increase of the LRF. This will provide the necessary predictability and functioning of the market. The longer the LRF is left unmodified, the more rapid decarbonisation is required in the remaining time until 2030. Therefore, a timely implementation ensures a smooth adaption of the ETS without market distortion as opposed to a one-off rebasing of the cap.

- **Increasing the auctioning share while decreasing free allocation of allowances**: Auctioning is the default allocation method for allowances in the EU ETS. It is the most transparent allocation method that provides a harmonised and non-discriminatory process. The principle of auctioning with the intent to gradually move to full auctioning is fundamental to the objective of emissions trading as it guarantees that costs of carbon are internalised. To this end, the more ambitious climate targets should be used as an opportunity to increase the share of allowances auctioned and decrease the allocation of free allowances. A linear and continuous increase of the auctioning share would provide the greatest possible predictability for market participants.

  Further, an increased auctioning share will also spur innovation and decarbonisation in industrial sectors where inclusion into the EU ETS has not yielded substantial reductions in emissions. Emissions in these sectors fell by just 2% compared to electricity and heat production where emissions were reduced by almost 15% in 2019.[1] In addition, this is particularly relevant as auctioning revenues significantly contribute to climate action by funding RES projects and other innovative low-carbon technologies in Europe.

- **Strengthening the Market Stability Reserve via a comprehensive quantitative analysis**: The Market Stability Reserve ("MSR") has been a significant benefit to the EU ETS and has proven its worth by ensuring stability and increasing prices in the emissions market.[2] In line with the increased 2030 emissions reduction targets, however, the parameters must be fit for purpose and adapted to the current market realities. While in principle Europex deems it reasonable to keep the MSR intake rate at a higher level beyond 2023, we would like to stress the importance of conducting a comprehensive analysis to determine the appropriate intake rate. Getting the MSR parameters right does not occur in a vacuum and changes to them require wider knowledge of the EU ETS context. To this end, **Europex recommends that the exact rates be based on an objective quantitative analysis once all EU ETS review design features have been decided on.** Ultimately, these changes must recognise that the MSR functions as a tool for market stability to manage supply and demand issues, whereas it is the LRF's role to strengthen the system.

[1] Report on the functioning of the European carbon market, COM (2020) 740 final [link].
[2] Report on the functionin of the European carbon market, COM (2020) 740 final [link].

2. An increased role for emissions trading

Europex sees the potential benefit in expanding the scope of the EU ETS to additional sectors such as transport and heating – or all fossil fuel use for the sake of efficiency. Emissions trading in these markets will ensure an economically efficient decarbonisation and provide market participants with a strong price signal to guide their economic activity and financial investments.

From a market perspective, the preferred option for implementing carbon pricing in additional sectors is their inclusion in the single European Emissions Trading System. Wide sectoral coverage encompassing a great number of diverse market participants optimises the efficiency of emissions reductions through a cross-sectorial price signal. Such an expansion would also ensure these sectors decarbonise efficiently. With an EU ETS expansion, the market as a whole, including all market participants, directly benefit from a larger, more efficient market with increased liquidity. Further, additional sectoral coverage can support linking of trading schemes as the system becomes more attractive for global partners to link with.

Having said this, it is important to acknowledge there might be potential unintended consequences when including new sectors directly into the EU ETS[3]. The ultimate framework for including these sectors in emissions trading at European level should preserve the integrity and efficiency that the common system has reached, while at the same time occuring relatively swiftly. To this end, **we consider that a separate system may be a reasonable way forward in the short- to medium- term.** This setup would allow the effects of ETS participation to be targeted to the specific sectors and be able to account for potentially diverging distributional effects or abatement costs.

In the long term, Europex believes the European Commission should aim to integrate these sectors into the EU ETS. To this end, flexibilities between the parallel systems can be introduced to smoothen this transition over time. This can be approached gradually by increasing fungibility as the market matures. Setting up a comprehensive timeline with indicators could be useful to provide guidance for the future integration.

3. Addressing the risk of carbon leakage in a way that is compatible with the EU ETS

Europex welcomes the Commission's efforts to minimise the risk of carbon leakage and ensure that the price of imports reflects more accurately their carbon content in line with the wider policies of the EU Green Deal. However, for the reasons explained above, the auctioned share of allowances should be increased to a higher level than the currently foreseen 57%. Expanding carbon pricing globally and intensified climate diplomacy is the most efficient remedy against carbon leakage and preserving European competitiveness.

[3] An expanded use of emissions trading to include road transport and buildings, and potentially all fossil fuel combustion, would affect individual spending on transport and heating fuels in the short or medium term, potentially creating challenges in terms of acceptability for the measure, distributional effects and impacts on vulnerable citizens. See the Commission's Impact Inception Assessment on Updating the EU ETS for further details [link].

For selected sectors, Europex supports replacing the current carbon leakage framework with a Carbon Border Adjustment Mechanism ("CBAM") that is as closely as possible integrated with the EU ETS. We believe that expanding the EU ETS to cover imports into the EU in this way would provide an effective alternative to free allocation and increase the auctioning share of the EUAs. This solution would act as an effective deterrent for emission leakage while simultaneously strengthening the international role of the EU ETS. By introducing a CBAM integrated with the EU ETS, this incentivises its alignment with other international carbon abatement instruments. To this end, a CBAM can be a transitional tool towards equivalent domestic carbon pricing systems, including future potential linkages of other emissions trading systems with the EU ETS. This solution would facilitate the expansion of carbon trading both within Europe and internationally, which ultimately constitutes the most efficient approach to address carbon leakage and to reduce global GHG emissions cost-effectively.

4. Funding of the climate neutrality and decarbonisation transition through market-based incentives

Market-based incentives to invest in renewable generation and innovative clean products should primarily come from a robust carbon price signal. Additional support is already granted to immature low-carbon and carbon removal technologies through investment grant mechanisms such as the Innovation or Modernisation funds[4]. In emissions and energy markets, market participants can already use the available short- and long-term trading products to efficiently manage their exposure to the carbon price signal, in parallel to other commodities. This market-based approach is the basis for the liquidity of the market, diversity and number of market participants in the system.

We continue to strongly discourage alternatives that may interfere with the functioning of the primary and secondary carbon markets, such as a carbon price floor[5] or carbon contracts for difference.

The introduction of instruments such as carbon contracts for difference (CCfDs), designed to guarantee carbon prices and reduce project financing costs, risks a negative impact on the carbon market. CCfDs cover the difference between a variable reference price (the price of allowances in the EU ETS) and a fixed agreed strike price. Whenever the allowance price falls below the strike price, the CCfD is triggered, resulting in a payment from the contracting party (typically the government) to the beneficiary. However, such socialised subsidy schemes lead to short- and long-term market price distortions, reducing the effectiveness of the price signal as a short- and long- term operational and investment decisions driver. CCfDs ultimately risk undermining markets which are used to manage exposure to carbon price risk. Publicly backed CCfDs pose particular problems in terms of their impact on the emissions

[4] Other forms of support and funding include the InnovFin Energy Demo Projects [Link]; Connecting Europe Facility grants [Link]; Horizon 2020 [Link], InvestEU Programme [Link]; Modernisation Fund [Link]; Just Transition Fund [Link]; and Enhanced European Innovation Council (EIC) pilot [Link].

[5] Please see Europex position paper '*Minimum carbon pricing is distortive and not needed – why free price formation should remain a cornerstone of the EU ETS' volume-based cap-and-trade mechanism*', 20 November 2020, for further detail [Link].

forward market, effectively reducing the need for market participants to hedge their risks on the derivatives market. Further, the cost of managing this risk is also ultimately transferred to the public, rather than managed via the competitive energy market.[6]

The evolving policy ambition and future carbon price developments must also be taken into account. Following the increase of the EU climate targets to a proposed 55-60% reduction in emissions and the commitment to carbon-neutrality by 2050, carbon prices are estimated to double over the next decade.[7] The upcoming Phase IV reforms aimed at reducing the volume of allowances in circulation will also further strengthen the carbon price. Strengthening the carbon price by setting an appropriate cap and LRF should be prioritised as it addresses potential concerns that the EU ETS carbon price is too low to allow low carbon product technologies to be competitive against higher carbon-intensive ones.

Other CCfDs drawbacks that must be considered include their limited effect to provide substantial protections to low-carbon production projects, their reliance on public funds, and asymmetry of information. First, CCfDs are usually awarded via competitive auctions and, while it can prevent leakage from the specific projects it covers, they do not offer any immediate competitiveness benefits for the sector at large. Secondly, relying on subsidies from governments when there are market solutions available should not be the way forward to fund the energy transition, particularly during times of tight budgets. Like other support policies, a CCfD relies on the availability of limited public funds to the detriment of the end consumer who will ultimately bear the increased costs. Lastly, information asymmetries can also make it difficult for governments to gauge the true cost of bidding technologies and the required carbon strike price, something that competitive bidding processes can alleviate, but not eliminate.

[6] The Europex response to the consultation on the '*EU offshore renewable strategy*', 24 September 2020, providing more detail on the potential negative market impacts of CfDs [Link].
[7] Some analysts suggest that carbon prices could increase by 50% over the next decade:
https://www.reuters.com/article/us-climate-change-eu-carbon-idUSKBN2682ZQ
https://www.argusmedia.com/en/news/2142240-eu-ets-price-3265t-under-2030-scenarios
https://www.edie.net/news/6/Carbon-prices-set-to-climb-by-50--over-next-decade-following-raised-EU-climate-targets/

About

Europex is a not-for-profit association of European energy exchanges with 29 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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Annex I

The Contribution of EU ETS to the overall climate ambition for 2030

With the increased 2030 GHG reduction ambition of at least 55%, what should be the current EU ETS sectors' contribution to the increased 2030 target (i.e. without the accounting for the possible inclusion of new sectors)?

- The current ETS sectors should increase their current ETS contribution (compared to 2005) in line with the new target. Based on cost-efficiency considerations as calculated in the Impact Assessment accompanying the Communication on stepping up the EU's 2030 climate ambition (table 26)

A strengthened EU ETS 2030 ambition can be achieved through different combinations of policy options. Considering the current EU ETS sectors, please rate the following aspects in terms of relevance? Please rate from 1 (not important) to 5 (very important):

	1	2	3	4	5
Strengthen the cap through the increase of the linear reduction factor					X
Strengthen the cap through a one-off reduction ('rebasing the cap')	X				
A combination of increasing the linear reduction factor and a one-off reduction	X				
Cancelling allowances held in the Market Stability Reserve (MSR)				X	
Maintain the increased feeding rate of the MSR after 2023				X	
Early application of a strengthened cap (e.g. 2023 instead of later)				X	

In view of a strengthened ETS cap and thus a decreasing absolute volume of allowances available for auctioning and free allocation, how should the total cap be divided?

- The auction share should be increased and free allocation decreased

Do you believe the current carbon leakage framework addressing direct carbon costs, consisting of free allocation, should be maintained, amended or replaced?

- For selected sectors, the current carbon leakage framework should be replaced by a Carbon Border Adjustment Mechanism
- Free allocation should be made conditional to beneficiaries carrying out investments for reducing their GHG emissions

Please explain your answer:

For selected sectors, Europex supports replacing the current carbon leakage framework with a Carbon Border Adjustment Mechanism ("CBAM") that is integrated in the EU ETS. This would provide an effective alternative to free allocation and increase the auctioning share of the EUAs. The CBAM would act as an effective deterrent for emission leakage while simultaneously strengthening the international role of the EU ETS. By introducing a CBAM integrated with the EU ETS, this incentivises the alignment of other international carbon

abatement instruments with the EU ETS, including future potential linkages of other emissions trading systems with the latter. This solution would facilitate the expansion of carbon trading both within Europe and internationally, which ultimately constitutes the most efficient approach to address carbon leakage and to reduce global GHG emissions cost-effectively.

Should the approach to indirect cost compensation be modified?

- Yes, the rapidly on-going decarbonisation of the electricity production in the EU will sufficiently reduce indirect costs and therefore, indirect cost compensation can be gradually phased out

Emissions trading for road transport and buildings or all fossil fuel use could be integrated into the existing EU ETS so that there would be one single system covering emissions from all these sectors. If the new sectors are integrated into the current EU ETS such integration would be:

- Positive, because it would capture the emissions under the cap and facilitate more cost-effective abatement by increasing abatement options
- Positive, because including buildings into an extended EU ETS would provide a level playing field for all modes of heating and cooling
- Positive, because including fossil fuels used in road transport into an extended EU ETS would provide a level playing field for all modes of road and rail transport, including electric rail which is already subject to indirect carbon pricing
- Positive, because including emissions from all fossil fuel use into an extended EU ETS would provide a uniform carbon price signal for all industries
- Negative, because there could be an insufficient price signal for the transport and building sector to decarbonise
- Negative, as the integration of the new sectors in the current ETS might disrupt and undermine the stability of the current ETS

A separate EU-wide emissions trading system for road transport and buildings or all fossil fuel use could be established as a parallel system to the current EU ETS. Flexibilities could be built in, e.g. to allow partial fungibility between the allowances of the separate systems. What is your preferred design option for the relationship between these two systems:

- Two-way flexibilities between the systems will increase cost-efficiency

Please specify:

1000 character(s) maximum

In principle, Europex sees the potential benefit in expanding the scope of the EU ETS to additional sectors. Having said this, it is important to acknowledge there might be potential unintended consequences when including new sectors directly into the EU ETS. To this end, we consider that a separate system may be a reasonable way forward in the short- to medium term. This set-up would allow the effects of ETS participation to be targeted to the specific sectors and be able to account for potentially diverging distributional effects or abatement costs. In the long term, Europex believes the European Commission should aim to integrate these sectors into the EU ETS. To this end, flexibilities between the parallel systems can be

introduced to smoothen this transition over time. This can be approached gradually by increasing fungibility as the market matures. Setting up a comprehensive timeline with indicators could be useful to provide guidance for the future integration.

Establishing a separate EU-wide emissions trading system for road transport and buildings or all fossil fuels will require choosing its main features. Which of the following aspects of the new ETS do you consider should be similar to the current ETS in order to allow for a later integration? Please rate from 1 (very similar) to 5 (very different):

	1	2	3	4	5
The level of ambition for emissions reduction					X
The linear reduction factor					X
Provisions to address distributional aspects, i.e. how revenues are divided and used		X			
Provisions to address carbon leakage issues in the energy intensive industry where appropriate	X				
Monitoring, reporting and verification rules				X	
The infrastructure to be used (e.g. the use of the existing EU ETS infrastructure such as the Union Registry)		X			
Application of the market stability provisions		X			

Emissions trading for road transport and buildings or all fossil fuels could be gradually integrated into the existing EU ETS. Should the ETS revision already determine when and how such integration will take place?

- Yes, the legislation should foresee a review to determine whether and when integration is desirable

What is your opinion on the most appropriate measure to put a price on GHG emissions from EU maritime transport activities?

- Extension of the EU ETS to cover maritime transport

Geographical scope

- Emissions from intra-EU voyages (from an EU port to another EU port) should be addressed by carbon pricing

Has the MSR delivered on its main objective (the stability of the ETS), and is it likely to fulfil its goals in the future, or should its structure or parameters be changed?

- Yes, the approach has worked well and should be continued, but parameters (e.g. volume-based thresholds, intake rate) should be modified

Please specify:

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The Market Stability Reserve (MSR) has created much benefit for the EU ETS and has proven its worth by ensuring stability and increasing prices in the emissions market. In line with the

uncreased 2030 emissions reduction targets however, it now needs to be ensured that the parameters are fit for purpose and adapted to the current market realities.
Europex supports measures that will help the carbon price and keep the surplus of allowances at a healthy rate. However, getting the MSR parameters right does not occur in a vacuum and changes to them require wider knowledge of the EU ETS context. To this end, Europex recommends that the exact rates be ultimately based on an objective quantitative analysis once all of the other EU ETS review design features have been decided on.

Should the MSR thresholds (minimum of 400 and maximum of 833 million allowances) used to determine whether allowances are placed in the MSR or released, be kept as they are?

- The thresholds should be reduced

Should the MSR intake rate be kept as it is or should it be increased or decreased?

While in principle Europex deems it reasonable to keep the MSR intake rate kept at a higher level beyond 2023, we want to stress the importance of conducting a comprehensive analysis to determine the appropriate intake rate. Getting the MSR parameters right does not occur in a vacuum and changes to them require wider knowledge of the EU ETS context. To this end, Europex recommends that the exact rates be ultimately based on an objective quantitative analysis once all EU ETS review design features have been decided on.

At the moment, emission allowances for aviation are not taken into account for the calculation of the EU ETS surplus and therefore do not influence the amount of allowances fed into or released from the MSR. Should aviation allowances and emissions be taken into account in the future?

- Yes

Are stricter rules necessary to ensure Member States spend their ETS auction revenues in line with climate objectives?

- Yes, the ETS Directive should require that Member States spend ETS revenues in a way compatible with the climate neutrality objective (‘do no harm’)

What should be the size of the Innovation Fund?

- The size of the Innovation Fund should remain unchanged

Currently the ETS Directive foresees that the maximum funding rate for projects financed by the Innovation Fund is 60% of the relevant costs. Should this rate be changed?

- No, some of the risk of innovation has to be borne by the project proponent

Should additional supporting instruments be introduced to support full market deployment of low-carbon products through the Innovation Fund? For example, as Carbon Contracts for Difference, whereby beneficiary projects would be guaranteed a fixed carbon price in case the ETS price is not high enough.

- No, the existing support is sufficient

What should be the size of the Modernisation Fund?

- The size of the Modernisation Fund should remain at 2% of the cap

Please specify:

1000 character(s) maximum

The current support level granted via investment grant mechanisms such as the Modernisation Fund to low carbon technologies Fund should remain at 2% of the cap because in emissions and energy markets, market participants can already use the available short- and long-term trading products to efficiently manage their exposure to the carbon price signal. Furthermore, following the increase of the EU climate targets to a proposed 55-60% reduction in emissions and the commitment to carbon-neutrality by 2050, and considering that the upcoming reforms will reduce the volume of allowances in circulation, carbon prices are estimated to double over the next decade. There is therefore no need to increment such aid anymore.

Should the types of investments that can be financed by the Modernisation Fund be streamlined and the coherence with the Green Deal be enhanced?

- Yes, the Modernisation Fund should be allowed to finance only non-fossil fuel based heating and cooling systems
- Yes, the Modernisation Fund should be allowed to finance only priority projects to simplify the administration