Europex

Supporting an EU ETS that is "Fit for 55"

- Feedback to the "Fit for 55" EU ETS review proposal -

Brussels, 5 October 2021 | Europex welcomes the holistic 'Fit for 55' Package as a decisive step towards achieving Europe's green transition. The package underlines the common understanding that **competitive energy and emissions markets must drive decarbonisation efforts to achieve the EU's green policy objectives at least cost to the economy and consumers, while ensuring a high level of competition and innovation.** As Europe's primary policy tool to combat climate change, the review of the EU ETS plays a fundamental role in delivering the EU's ambitious 2030 and 2050 decarbonisation targets and broader Green Deal objectives. Such a review must ensure continued commitment to strong market principles that safeguard the undistorted price signals, efficiency, transparency and liquidity of the emissions market.

Below, we provide our comments on key aspects of the proposal:

- **Increasing the current EU ETS sectors' contribution in line with the new decarbonisation targets:** To date, sectors included in the EU ETS have successfully delivered on meeting the set targets and reducing emissions. This stands in contrast to emissions reductions in non-ETS sectors where results are mixed and decarbonisation potential remains untapped. The Commission's proposal to increase the emissions reduction contribution from those sectors covered by the EU ETS to 61% by 2030 is a natural first step towards achieving the increased decarbonisation targets of at least 55% by 2030 and net zero by 2050. This will ensure that market-based mechanisms continue to successfully reduce greenhouse gas (GHG) emissions at least cost.

- **Strengthening the Linear Reuction Factor (LRF) to 4.2% in combination with a one-off downward adjustment of the cap:** Europex welcomes the increase of the LRF to 4.2% to tighten the annual supply of allowances and bring it in line with the increased decarbonisation targets accordingly. As a central parameter for determining the total number of allowances in circulation, it is important that the reduction rate be timely implemented to ensure its smooth application and avoid any disruption to the EU ETS.

  A clear, long-term increase of the LRF is preferable over a one-off rebase of the cap because it avoids big step changes that may impact market predictability or lead to sudden market movements. However, we appreciate that a one-off downwards rebasing of the cap may be implemented as an exceptional measure limited in scope and impact (i.e. not go beyond the "as if the new LRF rate would have applied already from 2021") and, most importantly, be communicated in a timely manner.

- **An increase of auctioning and a clear phase-out plan to end free allocation will provide the greatest possible predictability for market participants:** The reduction in the amount of allowances in circulation should entail a reduction of free allocation and the gradual move to full auctioning. Auctioning is the default allocation method for allowances in the EU ETS and remains the most transparent and non-discriminatory allocation method.

  To this end, Europex welcomes the Commission's proposal to introduce an increased update rate of 2.5% per year as of 2026 to bring it in line with the more ambitious decarbonisation targets. However, increased climate ambition should be seen as an opportunity to increase the share of auctioned allowances above 57% as currently set in Article 10. **A more concrete free allocation phase-out timeline for all sectors – beyond aviation or those sectors in scope of CBAM - should be included**. A linear and continuous increase of the auctioning share would provide the greatest possible predictability to the market and will spur innovation and decarbonisation in the industrial sectors for which its inclusion on the EU ETS havenot yet yielded substantial reductions in emissions.

  The time horizon for free-allocation phase-out for CBAM sectors should be reduced: While a phase-out of free allocation for sectors and subsectors covered by the CBAM was anticipated, 10 years with an annual reduction of 10% is too long. To ensure the EU meets its 2030 and 2050 decarbonisation targets, the period for the phase-out of free allocation for CBAM sectors should be furthered shortened.

- **The MSR as a key instrument in providing stability and trust to the EU ETS:** The MSR must continue to work efficiently to maintain the EU ETS' stability, as it has done since becoming operational in 2019. As such, Europex welcomes the proposals to update its thresholds to extend the 24% Total Number of Allowances in Circulation (TNAC) intake rate and adjust the intake mechanism thresholds, as well as to include aviation emissions and allowances from the maritime sector in the TNAC calculations. Importantly, it is crucial that the carbon market continues to operate smoothly and independent from the ongoing negotiations by the co-legislators, which must not cause any disruption to the market. Consequently, Europex sees merit in having the related adjustments to the MSR be fast-tracked, for the sake of market stability.

- **The integration of the maritime transport activity into the EU ETS will present important benefits for the reduction of emissions in the shipping sector:** In particular, the introduction of full auctioning of allowances will help to efficiently achieve the desired decarbonisation targets in the maritime sector. In addition, the alignment with IMO standards in the long-term will improve its effectiveness and harmonisation.

- **A new, adjacent ETS for buildings and road transport is an ambitious yet necessary step towards reaching the climate objectives:** Europex sees the potential benefit of expanding the scope of the EU ETS to additional sectors in order to further incentivise their decarbonisation. The Commission's proposal to have a separate, adjacent ETS for buildings and road transport with its own MSR mechanism is a reasonable way forward in the short- to medium-term. Having said this, with the first climate targets less than a decade away, this system should be operational as soon as possible. A 2026 implementation date seems relatively late and would require a very steep reduction in emissions in the first years.

In the long term, Europex believes the European Commission should aim to integrate these sectors into one EU ETS. 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 future integration.

- **Europex stresses the importance of carefully deliberating the necessity of introducing potentially market distortive instruments, such as CCfDs, into the EU ETS:** CCfDs may raise particular problems for the emissions forward market by interfering with the free price formation of the EU ETS and, thus, may have a major impact on competition and trade across-all sectors included therein. Notably, the need for hedging may decrease if state-backed CCfD instruments artificially secure a future carbon price. This would in turn reduce overall liquidity and interfere with the free price formation in the EU ETS, resulting in less efficient price-formation. As it stands, the proposal of the Commission to increase the size of the Innovation Fund and extend its scope to provide support to projects through competitive tendering mechanisms such as CCfDs remains too broad and vague.

  The following points should be thoroughly considered:

  1. First, financing the allocation of CCfDs from the Innovation Fund may introduce serious budget risks. For example, if the price of allowances goes down, the resources of the Innovation Fund will also decrease and the necessary pay-out for CCfDs would therefore increase. CCfDs unnecessarily and fully transfer risks to the government entity, whereas the EUA derivatives markets exist exactly for this purpose.

  2. Secondly, the carbon markets' current context and price trajectory must be taken into consideration. For many years, the price level of European Emission Allowances (EUAs) has not been seen as sufficiently high or stable enough to support nascent low-carbon technologies in becoming competitive with more polluting alternatives already available at scale. Against this background, CCfDs have been touted as the ideal complementary policy needed to create markets for low-carbon materials. In its impact assessment, the references that the Commission cites to justify the introduction of complementary policies such as CCfDs base themselves on EUA prices being "around 25-30€/tCO2" and claim that in order to be competitive, carbon prices would need to be "at least 50€/tCO2 - 60€/tCO2", depending on the material.[1] Currently, carbon prices are within, if not over,

[1] Footnotes 46 and 47, COM(2021) 551 final, 2021/0211 (COD), 14.7.2021: https://www.iddri.org/sites/default/files/PDF/Publications/Catalogue%20Iddri/Etude/201910-ST0619-CCfDs_0.pdf; https://ec.europa.eu/clima/sites/clima/files/innovation-fund/swd_2019_85_en.pdf.

the competitive price threshold range, and it is well established that expectations are for the carbon price to further increase over the coming years. Europex therefore questions whether the introduction of CCfDs is truly justified. Concerns that the EU ETS carbon price is too low to allow low carbon product technologies to be competitive has become outdated.

3. Finally, should the Innovation Fund nevertheless be extended to provide support to projects through aid mechanisms such as CCfDs, at the very least further guidance should be provided regarding:

- **The scope of the CCfD schemes,** which should have a pre-determined maximum budget including a trial phase with limited sectoral participation;
- **A clear phase-out timeline** for the duration of CCfD aid schemes;
- **The reference price** for CCfDs should be carefully considered and determined in the most market-neutral manner; and
- **The framework guidance on the design of CCfDs should be developed at European level** to avoid diverging national implementation leading to an uneven playing field for the industry.

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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