Carbon Market Watch response to Inception Impact Assessment on the EU ETS

Key elements for the revision of the EU ETS

The upcoming revision of the EU Emission Trading System represents a crucial opportunity to strengthen the Directive and ensure it contributes to the goals of the Paris Agreement.

Carbon Market Watch believes that the upcoming review should include the following elements.

1. An increase of the Linear Reduction Factor (LRF) and a one-off reduction of the cap, with the aim to reach zero emissions by 2040 to make the EU ETS compatible with the goals of the Paris Agreement.
2. A strengthened Market Stability Reserve: the intake rate should be increased to 36% from 2024 onwards, declining thresholds should be adopted and an automatic cancellation for allowances held in the MSR for more than five years should be set.
3. Full auctioning of emission allowances
4. 100% ETS auctioning revenues earmarked towards industrial innovation, modernisation, just transition and international climate finance
5. Do not include road transport and buildings
6. Include international maritime transport and waste incineration
7. If CBAM is implemented, extend the EU ETS to cover importers' emissions and phase out other carbon leakage measures
8. No Carbon Dioxide Removal (CDR) credits

In the attached document, we outline more in detail all the elements listed above.

The upcoming revision of the EU Emission Trading System represents a crucial opportunity to strengthen the Directive and ensure it contributes to the goals of the Paris Agreement.
The review should include the following elements:

1. **Make the EU ETS compatible with the goals of the Paris Agreement (PA).**

   For the EU to keep its commitment under the PA, the EU ETS should contribute to a 65% emissions reduction by 2030 and to reaching climate neutrality by 2040. It is therefore crucial that the ETS revision focuses on an increase of the Linear Reduction Factor (LRF) and a one-off reduction of the cap, with the aim to reach zero emissions by 2040. It is essential to review and implement both elements by

2023, as later implementation will require a steeper LFR and a larger one-off reduction.

2. **Strengthen the Market Stability Reserve (MSR)**

   The MSR has played a key role since its implementation, and proved effective in supporting the ETS carbon price signal in recent years. However, the MSR was designed to only handle oversupply accumulated in the past. It is not fit to deal with current or future surplus (linked to e.g. the Covid-19, economic downturn, planned coal plant closures...). The MSR will therefore need to be strengthened in the context of the ETS revision. The intake rate should be increased to 36% from 2024 onwards, declining thresholds should be adopted and an automatic cancellation for allowances held in the MSR for more than five years should be set.

3. **Mandate full auctioning of emission allowances**

   Emissions from industrial installations like steel, cement and chemicals continue to stagnate (less than 1% annual reduction since 2013) and those from aviation keep increasing (>4% annual increase since 2013). Despite auctioning being the default rule, 94% of industrial emissions, and about half of emissions from aviation, are currently covered by free emission allowances.The European Court of Auditors has recently found that free allocation of allowances to industry and aviation could slow decarbonisation, and needs better targeting. Given that the European Commission accepted this recommendation, the upcoming impact assessment should include options leading to full auctioning for all sectors.

4. **Recycle more revenues towards industrial innovation, modernisation, just transition and international climate finance**

   While EU Member States claim that a large part of ETS auctioning revenues are used for climate action, the Directive lacks harmonised obligations to ensure similar practices in all EU countries. This is caused by the non-binding provision that only at least 50% of auctioning revenues “should” be used for climate and energy related purposes. The EC should propose earmarking 100% of revenues for climate action, to invest in renewable and energy efficient technologies, clean industrial innovation, just transition and international climate finance.

5. **Do not include road transport and buildings**

   Extending the EU ETS to road transport and buildings would have little to no impact on emissions, and risks becoming a distraction from existing climate policies in those sectors. By removing these sectors from the Climate Action Regulation, national governments would no longer be incentivised to take national action. Furthermore, social impacts will be negative if citizens were forced to pay higher prices for energy without having the possibility of choosing cleaner alternatives.

6. **Include international maritime transport and waste incineration**

   Given the lack of progress at the global talks to tackle carbon pollution at the International Maritime Organisation (IMO), the European Commission should move forward with the European Parliament position from the shipping MRV file to swiftly extend the EU ETS to international shipping.

   Municipal waste (MSW) incinerators should be included in the EU ETS. This would make waste incineration more expensive - encouraging other more sustainable and low-carbon waste treatment options, and driving better waste management. Evidence shows that MSW incineration has a growing negative impact on the climate but still incinerators are not covered by the EU ETS or similar climate obligations.

7. **If CBAM is implemented, extend the EU ETS to cover importers' emissions and phase out other carbon leakage measures**

   The introduction of a Carbon Border Adjustment Mechanism will need to go hand-in-hand with the swift phasing out of free emission allowances. The overlap of the two systems would mean double protection from a risk that has not materialised yet and is unacceptable.

8. **No Carbon Dioxide Removal (CDR) credits**

   While CDR will likely be needed in the longer term to reach climate neutrality, it and related MRV systems are not yet mature for inclusion in the EU ETS. CCU is not permanent storage and should be excluded from the EU ETS.