



Carbon Market Watch's feedback to the European Commission's consultation on "Climate change - updating the EU Emissions Trading System"

November 2021

The revision of the EU Emissions Trading System (ETS) represents a huge opportunity to strengthen the Directive to ensure it is in line with the 1.5°C target under the Paris Agreement. However, the European Commission's proposal includes two major shortcomings that should be reconsidered. Firstly, the EU-wide 55% emission reduction target proposed is inadequate to achieve the goals of the EU Green Deal and the Paris Agreement, and it should be upgraded to 65%. Secondly, the proposal neglects to properly implement the polluter pays principle. The free handouts of emission allowances to large polluting industries represent a market failure which will lead to continued windfall profits to the sectors concerned.

Carbon Market Watch presents its priorities to improve the Commission proposal below.

1. Ensure that the Linear Reduction Factor (LRF) and the one-off reduction of the cap result in a 70% decrease in emissions by 2030 for the ETS sectors

The proposal puts forward an increased **Linear Reduction Factor** (4,2 %) combined with a one-off adjustment of the cap so the new linear reduction factor has the same effect as if it applied from 2021. However, the overall climate target to be achieved by the EU ETS by 2030 is -61% below 2005 level, which is not in line with the level of emission reductions needed to limit the climate crisis.

A 70% target for current ETS sectors (compared to 2005) is more in line with the urgency of the climate crisis. To achieve this target, the one-off reduction of the cap proposed by the Commission should be strengthened. This would allow closing the gap between the ETS cap and actual emissions in order to better manage the market oversupply and ensure its resilience. Based on the impact assessment accompanying the 2030 climate target plan¹, and the latest Commission Climate Action progress report published at the end of October 2021², the gap stands at around **450 million allowances. The ETS cap should be reduced by the same number.**

¹ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020SC0176>

² https://ec.europa.eu/clima/system/files/2021-10/com_2021_960_en.pdf

2. Adopt stronger parameters for the Market Stability Reserve

The Commission proposal to maintain the **Market Stability Reserve (MSR)** intake rate at 24% (instead of reducing it to 12%) until 2030 and cancelling allowances held in reserve above 400 million both help strengthen the MSR. However, the tool is weakened by the inclusion of aviation and maritime emissions that reduce the number of allowances absorbed by the MSR and its parameters are not strong enough to absorb re-emerging oversupply of emission allowances in the coming years.

The revision of the MSR must support a meaningful price signal and ensure stability and resilience of the EU carbon market, including in case of predictable external shocks such as the phase out of coal and lignite power plants and post-Covid economy rebound. For example, if the next German government agrees to a faster timeline for phasing out coal and lignite use in the power sector, this will lead to outdated assumptions and an underestimation of the oversupply of allowances compared to the impact assessment as developed by the Commission. A higher intake rate and more dynamically declining thresholds for the MSR should be considered.

In order to strengthen the MSR, the following key elements should be considered:

1. **The intake rate should be increased to 36% from 2024 onwards.** As shown by the Oeko-Institut 2021 study on the MSR³, a combination of such a higher intake rate together with a one-off reduction of the cap, can help to accelerate the system's responsiveness to sudden increases in emission supply.
2. **All allowances held in the MSR for more than 3 years should be cancelled.** This provision is an improvement building on the Commission proposal and would ensure market predictability as well as the environmental integrity of the EU ETS. It would entail the permanent cancellation of allowances from the system, thus avoiding the risk of future oversupply returning to the market.
3. **The MSR thresholds should decline to zero by 2030.** This more dynamic design of thresholds would be more aligned with enhanced climate ambition and the actual hedging needs of the power sector. Since the hedging demand of power companies is likely to fall as the sector continues to decarbonise, the upper and lower thresholds that trigger the MSR intake rate should decrease over time and reach zero by 2030.

³ <https://www.wwf.de/fileadmin/fm-wwf/Publikationen-PDF/Klima/WWF-Studie-Emissionshandel-englisch-alt.pdf>

3. Phase out free emission allowances

The ETS proposal fails once more to apply the polluters-pay-principle by not putting an end to free emission allowances for resource- and energy-intensive industries. Evidence from the European Court of Auditors report (2020)⁴ has proved that free allocation of allowances tends to slow down the industrial decarbonisation process. Over half of all EU ETS allowances have been given out for free since the ETS was created, with little emission reduction achieved in return.

This means the problem of pollution remains unaddressed and EU industry has often failed to shift to cleaner technologies and production processes. Those industries that have invested in low or zero-carbon techniques are being undermined by a system that continues to reward large polluting installations.

Free emission allowances should be phased out immediately. Polluting for free in times of a climate crisis is unacceptable. Cosmetic changes that the European Commission proposed for “better targeting” of free emission allowances will not drive the necessary emission reduction needed to achieve climate neutrality by 2040.

In particular, the changes suggested to the current benchmark system fall short to implement the polluter pays principle and to phase out free emission allowances in a timely manner:

- Despite setting a higher maximum annual reduction rate of the ETS benchmark (2.5% instead of 1.6%), the proposal keeps the minimum annual reduction rate at 0.2%. The minimum annual reduction rate applies to some of the most polluting products such as steel, cement and ammonia and it's much too slow to incentivise the decarbonisation of these sectors well before 2050. Moreover, as shown in the impact assessment accompanying the ETS proposal, the potential for emission reductions in ETS sectors is much higher than 0.2% a year⁵. The minimum annual reduction rate of the benchmarks should therefore be set at 1%. The specific provision exempting the hot metal benchmark from a fact-based assessment of technological progress in the steel sector should be discontinued⁶.

⁴ <https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=54392>

⁵ https://ec.europa.eu/info/sites/default/files/revision-eu-ets_with-annex_en_0.pdf (page 87, Annex IV)

⁶ Specifically the provision in ETS Directive Art 10a(2) last paragraph: “the benchmark value for hot metal [...] shall be updated with an annual reduction rate of 0,2 %”

Table 43: Assumed annual average improvement in the GHG emission efficiencies per sector for the modelling of emissions

Sector	Annual average GHG emission improvement
Cement	1.0%
Lime	1.0%
Refineries	1.5%
Iron and steel	1.0%
Fertilisers	2.0%
Ceramics	1.0%
Non-ferrous metals	1.5%
Chemicals	1.0%
Pulp and paper	2.0%
Glass	1.0%

Source: Commission assumptions based on Fraunhofer Institut, ICF and DECHEMA studies.

→ **The 0.2% minimum reduction rate should be updated to 1% / delete Art 10a (2) last paragraph.**

- The 25% reduction of free allowances conditional on the compliance with energy audits is a step in the right direction. However, this only adds value if it leads to new and additional investments in energy savings, with the conditionality involving a 100% reduction of free allowances if the installation does not follow energy efficiency requirements. Moreover, the chosen payback time of 5 years is unnecessarily short and for large energy consuming sectors under the EU ETS Directive should be extended to 10 years, as these sectors with long-living infrastructure require additional incentive to rationalise their energy consumption. The conditionality should also be strictly applied to the fulfillment of the energy efficiency recommendations without providing any opportunity for alternative investments that could lead to the same emission reductions.
- The Commission proposal to amend ETS Directive Art.10a includes a loose reference to the “*Union-wide ex-ante benchmarks*” to be reviewed before the period from 2026 to 2030 “*in view of potentially modifying the definitions and system boundaries of existing product benchmarks*”. This provision opens the possibility for a much deeper and structured revision of the ETS benchmarks. However, it remains very vague on the extent to which

this revision would take into account the full potential of product substitution and the circular use of materials. In addition, there is no reason to delay this process until 2026, as the Commission clarified in June 2021 that the review of Article 10a and final levels of free allocation may be subject to change for the allocation period from 2021 to 2025⁷.

→ The revision of the ETS benchmarks should start much sooner than 2026 and within 6 months from the entry into force of the ETS Directive.

→ In order to account for the full potential of product substitution and the circular use of materials, the definitions and system boundaries of product benchmarks should be revised to take these features into account.

- The European Commission missed again the opportunity to include a provision in Art. 10b for tiering carbon leakage risk and better targeting free allowances.
 - As shown in the impact assessment⁸, a better targeting of free allowances is possible through a tiered approach that ranks sectors according to their real exposure to carbon leakage risk. This would reduce foregone revenues for member states and create more incentives for industries to invest in decarbonisation. However, this option is only discussed as an alternative to strengthened product benchmarks discussed above. As such, it is argued that the proposed changes to ETS benchmarks would be more impactful and would lead to the application of the cross-sectoral correction factor earlier than the tiered approach. The best outcome would be in fact yielded by the application of both options discussed in the impact assessment. A much more meaningful and targeted approach would be the application of tiering of free allocation in addition to the proposed revision of the ETS benchmarks. The combination of the two would ensure that free allowances are allocated in full only to sectors at real risk of carbon leakage, and that new processes and technologies are properly accounted for to incentivise cleaner production and deeper emission reductions in line with climate neutrality before 2050.

→ The two options for better targeting free allocation presented in the impact assessment should be complementary and applied simultaneously

⁷ https://ec.europa.eu/clima/news-your-voice/news/commission-publishes-national-allocation-tables-member-states-eu-ets_en

⁸ https://ec.europa.eu/info/sites/default/files/revision-eu-ets_with-annex_en_0.pdf

- Additionally, the proposal includes a major departure from the Commission's stated aim announced as part of the EU Green Deal that a Carbon Border Adjustment Mechanism (CBAM) would be implemented as “alternative to the measures that address the risk of carbon leakage [i.a. free allowances] in the EU’s Emissions Trading System”⁹ Yet the Commission’s CBAM proposal would maintain free allocation to sectors covered by CBAM until 2035. This is extremely counterproductive as the current ETS Directive contains no provisions extending free allocation beyond 2030.
 - **The revised ETS Directive should exclude any provision allowing the overlap between free allocation of emission allowances and CBAM. Moreover, for sectors not covered by CBAM, no free allocation should be envisaged after 2023.**

4. Strengthen transparency and fairness of the Innovation Fund and Modernisation Fund

Innovation Fund

Increases in the volume and scope of the ETS Innovation Fund (IF) are positive and greatly needed to incentivise industrial decarbonisation. The increased flow of allowances resulting from the reduction of free allowances for sectors covered by CBAM into the Innovation Fund is particularly welcome.

However, if free allowances were phased out, more funding could be directed towards the Innovation Fund and contribute more substantially to zero-carbon projects in energy-intensive industries.

→ The additional 150 million of allowances to fund innovative low-carbon projects under the IF should be taken from the share of free allowances in the main ETS instead of the new ETS for road transport and buildings.

Modernisation fund

The proposal very positively removes any support for energy generation facilities that use fossil fuels. Moreover, it expands the Fund’s scope and resources, increasing the share of allowances that will be directed towards the Fund to 4.5% and the GDP per capita threshold thereby

⁹ <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1576150542719&uri=COM%3A2019%3A640%3AFIN>

including Greece and Portugal among the countries that can receive funding through the Modernisation Fund.

It is crucial for these changes to be kept in the final Directive, in particular, the exclusion of funding for fossil fuel infrastructure and gas as transition fuel.

With regards to the selection of projects to be funded under the Modernisation Fund, the ETS Directive should ensure **more transparency and accountability**, as well as **stricter criteria**.

Projects funded through the MF should be aligned with Territorial Just Transition Plans. This would ensure the firm exclusion of investments in any type of fossil fuels and full consistency across EU climate and energy legislation. It will also oblige governments to be coherent in their planning in the regions in transition and avoid having multiple disjointed plans that risk being incoherent.

5. Include stricter criteria for the use of ETS revenues

The proposal very positively mandates the full use of revenues for climate related purposes, which is an improvement compared to the current ETS.

The new requirement included in the proposal needs to be maintained. Indeed, as shown by a recent report by WWF, several member states failed to channel the ETS revenues to climate action¹⁰.

However, the proposal fails to define the list of criteria and activities on which ETS revenues should be spent. While EU member states should be free to decide on what to spend ETS revenues, stricter criteria should be put in place to avoid misuse of funding and resources going to finance unsustainable technologies and practices that are not in line with the goal of reaching climate neutrality by 2050.

→ The list of criteria and activities on which the revenues should be spent must be refined and mandated to ensure that member states spending goes to support climate action. As

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https://wwfeu.awsassets.panda.org/downloads/making_eu_ets_revenues_work_for_people_and_climate_summary_report_june_2021__2_.pdf

suggested in WWF's report on the use of ETS revenues¹¹, projects funded through ETS revenues should contribute substantially to at least one of the six environmental objectives

and be compliant with the 'do no significant harm' principle included in the EU Sustainable Finance Taxonomy. They should also be consistent with National Energy and Climate Plans and Territorial Just Transition Plans, and comply with minimum social safeguards.

6. Cover all incoming and outgoing voyages and apply full auctioning in the shipping sector from the start

The proposal for shipping includes several good elements, including no free allocation, using the most recent data to set the baseline for expanding the cap and explicitly making shipping companies eligible for Innovation Fund finance.

However, there are still a few glaring issues which need to be addressed. The slow phasing in of full compliance requirements ignores the urgency of tackling emissions from the shipping sector. There is no need whatsoever for a slow phase-in as carbon leakage risks are close to non-existent and the shipping industry has already had a sufficiently long phase-in due to the MRV for shipping regulation. The industry already conducts the MRV necessary and knows perfectly what they emit.

Second, the current geographic scope includes intra-EU voyages, ships at berth and 50% of incoming and outbound voyages (to and from EU ports). This should be expanded to cover all international shipping emissions. There are no stringent climate measures in place globally for this industry, and full-scope EU ETS inclusion would ensure more pollution from EU economies is priced. The coverage of voyages to third countries implementing similarly stringent climate policies could be revisited to ensure each country prices 50% of those trips. This would also be seen as a basis for international cooperation and incentivize third countries to price pollution from the shipping industry.

→ Shipping companies should be required to surrender allowances equal to 100% of their verified emissions as of 2023. And all incoming and outgoing voyages should be fully covered.

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https://wwfeu.awsassets.panda.org/downloads/making_eu_ets_revenues_work_for_people_and_climate_summary_report_june_2021__2_.pdf

7. Exclude Carbon Capture and Utilization from ETS

The addition of Carbon Capture and Utilisation (CCU) to the EU ETS Directive (Articles 3 point (b) and Article 12(3b)) is highly problematic.

Under this proposal, companies would not be required to buy allowances to cover their CO₂ emissions, if the carbon captured and used in an industrial process is ‘permanently chemically bound in a product’ and does ‘not enter the atmosphere under normal use’. The theory behind this is that industrial carbon would be captured by companies, and used to create other products (such as fuels, building materials or plastics). This carbon would then be automatically considered permanently stored if it was not released during use.

This ambiguous language is very problematic and could create damaging loopholes in the ETS legislation.

Products that release carbon after their normal use (for example while decomposing or in incinerators) should not be considered carbon storage: CO₂ can only be deemed permanently stored if it is never released into the atmosphere again.

Moreover, the capture of carbon and the process to turn it into a product could be highly emitting activities, such as when the carbon comes from fossil fuels and the electricity used is fossil fuel-based. Emissions throughout the value chain of the CCU product need to be calculated so that only products that really decrease overall carbon emissions are incentivised. Otherwise, the EU would be promoting increased emissions instead of reducing them.

In addition, the inclusion of CCU could lead to EU ETS emissions being shifted to the ESR sectors increasing the burden on Member States to reach those targets.

→ The inclusion of CCU in the EU ETS should be excluded from the Commission's proposal

If EU policymakers are keen to support carbon capture and utilisation, they should ensure that the product is a net permanent store of carbon over its entire lifetime. All emissions during production, use and recycling/disposal need to be counted and properly accounted for. Failing to do so would just create another opportunity to avoid real efforts to decarbonise.

8. Delete article 26 of the ETS Directive



The Commission's proposal fails to recognise the potential for integrating the EU ETS and the Industrial Emissions Directive. Not amending Art. 26, to make the EU ETS and the Industrial Emissions Directive complementary and include GHG emissions within the scope of the IED was a big, missed opportunity to set binding emission limits and energy efficiency standards in industrial permits.

While recognising that the decarbonisation of industry and power generation would also lead to reduced emissions of air pollutants and positive effects on air quality, and that the ETS and the IED have the potential to reinforce one another to reduce emissions, the proposal fails to better integrate these two crucial pieces of legislation.

The limitations imposed by art.26 are counter-productive and incompatible with the European Green Deal and the integrated approach of the IED to prevent pollution at source. They also provide little incentive to industries to invest in more environmentally friendly processes and move towards climate neutrality. In light of the urgent need to tackle the climate crisis, this oversight and shortcoming needs to be corrected.

→ Article 26 should be deleted to ensure that limits on greenhouse gas emissions can be set in environmental permits under the EU industrial emissions directive.

9. Include waste incineration in the EU ETS

The Commission's proposal fails to recognise the impact of waste incineration on the climate. Not including waste incineration under the EU ETS is another missed opportunity to better regulate this highly polluting sector and provide incentives for waste reduction.

As shown by a recent report from CE Delft¹², including waste incineration in the EU ETS would benefit the climate and the environment by reducing waste and encouraging recycling. The study estimates a reduction of CO₂ emissions by 2.8 to 5.4 Mt per year in 2022 and 4.3 to 8.8 Mt per year in 2030, with the greater impact as well as environmental benefits coming from commercial and industrial waste.

→ Municipal Solid Waste incineration plants should be added to Annex I of the ETS Directive

¹² https://zerowasteurope.eu/wp-content/uploads/2021/10/ZWE_Delft_Oct21_Waste_Incineration_EUETS_Study.pdf

10. Revise biomass accounting

The proposed changes to the rating of biomass in the ETS proposal are not strong enough to ensure proper accounting and support only for the use of sustainable biomass. The zero rating of biomass greenhouse gas emissions should be revised in order to ensure that it fully reflects the balance of the net effect of the production and use of bioenergy and gets rid of perverse incentives that can increase greenhouse gas emissions.

To this end, the ETS review should include a link with proper life cycle accounting for biomass that accounts for the real effects on CO₂ levels in the atmosphere. Biomass should not be considered zero-rated and it should be brought in line with strict sustainability criteria.

As proposed by the European Academies Science Advisory Council¹³, this could require calculating the ‘carbon payback period’ for each biomass facility and its supply chain. Regulators need to know how long it takes for the initial negative effects of burning biomass on climate to be overcome and net reductions in atmospheric CO₂ concentrations achieved. Once this is established, the relative proportion of biomass emissions should be reported in the ETS and allowances should be surrendered for compliance by installations using biomass.

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¹³ https://easac.eu/fileadmin/PDF_s/Press_Releases/EASAC_ETS_PR_Annex.pdf