CARBON MARKET WATCH

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# CMW feedback on the ETS review proposal

Carbon Market Watch appreciates the opportunity to give feedback on the proposed revision of the Emissions Trading System (ETS) Directive. You can find an overview of our views on key elements of the proposal below.

## Overall assessment

Launched during a summer of fossil-fuelled climate breakdown marked by heatwaves and wildfires, the European Commission's carbon market revision backtracks on climate action. It proposes increasing the EU's emissions by 2 billion tonnes of $CO_2e$, and risks undermining the achievement of the EU's 2040 and 2050 climate targets. **The proposal defends the polluting status quo and is counterproductive** to addressing the devastating impact of fossil fuels on competitiveness, household budgets, and the climate.

The proposal would also set back industrial investment. Strategic Perspective's analysis shows that industrial investment in decarbonisation could fall by €90 billion due to the weakening of ETS1 rules.

We welcome that the proposal leaves the ETS2 alone, considering it has already been significantly weakened and delayed over the last year. The co-legislators should not reopen ETS2, and leave it alone in this revision. Rather than further tampering with ETS2, policymakers should put pressure on laggard countries to do their homework: transpose ETS2, unlock early revenues and deliver robust Social Climate Plans with inclusive stakeholder consultation that help people through the necessary transition.

The EU needs to get serious about dumping its dependence on fossil fuels, and tackle climate change and industrial competitiveness at the same time. A green Europe is a competitive Europe, and the ETS is a critical tool to enable both.

While the Commission proposal contains a few positive elements (e.g. integrating waste incineration and private jets, attaching some thin strings to free allocation), **CMW view the proposal as woefully inadequate in light of the ever-increasing urgency of the climate crisis.**

If the co-legislators don't rectify many of the mistakes proposed, ETS1 risks becoming irrelevant again - reversing two decades of hard-won progress.

## Carbon budget and 2040-climate target non-alignment (LRF and MSR1)

- Modelling by Climact estimates the proposal will lead, at best, to an 80% decrease in CO2 emissions by ETS sectors by 2040 compared to 1990. This is far off the EU's net 90% target. Even though international credits are not an acceptable option for the EU and the mere signal that they are part of the 2040 framework harms the domestic transition, these credits will likely not be available or affordable to offset up to 5% of 1990 emissions (as set out in the Climate Law). This means ESR and LULUCF targets will need to be significantly raised to keep the net 90% target reachable and reduced at a pace at least 7-8 times faster than in the past.
- Öko-Institute concludes that the Commission proposal will lead to 'significant oversupply between 2031 and 2040', raising the spectre of another lost decade for the ETS due to lingering oversupply causing a depression of carbon prices.

**Policy recommendations:**
→ Maintain LRF at 4.4% until 2035 to lower risk of oversupply, and 2.7% thereafter
→ Maintain the MSR1 invalidation clause and keep its intake rate at 24%.

## Free allocation

- The proposal would allow for a staggering 3.2 billion free allowances between 2026-2040 according to Climact, which could increase by at least a further 80 million due to the revision of the fallback benchmarks. This means that an obscene 74% of all industrial emissions would still be covered by free allocation.
- On CBAM, there is no need to further delay the introduction of the CBAM and related phase-out of free allowances. International partners have already mobilised to follow the current CBAM timeline and specific export concerns can be tackled via dedicated funding for best performers.

**Policy recommendations:**
→ Maintain the current CBAM factors to ensure investment certainty and avoid penalising first movers: all free allowances for CBAM sectors are phased out by 2034.
→ Plan a full phase-out of free allowances for non-CBAM sectors within the CBAM timeline (2034) or at the very latest within the next trading period (2031-2040).

## Conditionalties

- Investment conditionality of free allocation is a no-regret policy that should cover any residual free allocation and indirect cost compensation. The need to align "Invest in EU" plans with 2050 climate neutrality, the equivalence in value between free allocation received and decarbonisation investments required, the full rejection of offsets in the decarbonisation plans, and the new clawback provision in case of relocation of production activities are all very welcome steps forward. However, the strings attached remain too thin.

**Policy recommendations**:
→ At least 80% of free allowances, not just 20%, should be linked to proven additional decarbonisation investments and not only theoretical plans.
→ Include baseline social requirements for any free allocation to be awarded ensuring compliance with Union and national labour and social legislation, and respect for rules on collective bargaining.
→ Include explicit conditions to ensure and maintain quality jobs and facilities in the clawback mechanism.
→ If indirect cost compensation continues, apply the same strict conditionality framework to its recipients

## International credits

- Article 6 credits carry significant environmental quality (including overcrediting) and human rights concerns. The Article 6.4 rulebook is simply not robust enough to ensure the transparent trade of high-quality carbon credits. International credits will be nowhere near equivalent to EU emission reductions. The projected availability of high-integrity, high-quality and affordable credits will likely not be sufficient to fulfil the 5% amount of international credits as foreseen by the European Climate Law.

- Offsetting ETS emissions (even indirectly) will waste valuable EU resources (€32 billion - assuming an average EUA price of €122) that could be invested in climate action by European companies or to support households through the transition.

**Policy recommendations**:
→ Reject any direct or indirect inclusion of international credits in the ETS.
→ At the very least, don't start from assuming the availability of a trustworthy supply of 'high quality' with an option to increase the LRF if these credits don't materialise. Rather, turn around the LRF fallback mechanism to provide predictability and signal a clear intent to use a very high standard when purchasing credits. The second tier of LRF should only be lowered in case a trustworthy supply of 'high quality' credits is proven in an assessment in 2033.

## Removals

- The integration of carbon removals in ETS is premature, does not help the development of a mature, safe and broad CDR industry and leads to mitigation deterrence. The CRCF methodology is deeply flawed, and in many respects sets even lower standards than the Article 6.4 framework. Sustainable permanent removals should be addressed and supported through a separate mechanism and policy.
- The details of the Commission's approach to integrating removals in the ETS are particularly concerning. The pollution space of the ETS would be increased by an additional 250 million allowances on top of the cap, with no guarantee that selling extra EUA will result in equivalent and high-quality CDR. This will cause direct mitigation deterrence, and risks resulting in millions of extra-cap tonnes of CO2 that could derail the road to 2040. It also sets a very problematic precedent of raising funding by printing allowances on top of the cap, undermining the trust in the ETS and the predictability of the cap.
- If taken forward, the indirect inclusion through a central purchasing platform and the exclusion of biochar are basic safeguards to be maintained.

**Policy recommendations**:
→ Reject any inclusion of carbon removals.
→ If integration in the ETS is to play a role in funding permanent removals (which we disagree with, as other less damaging and more predictable funding sources exist), keep carbon removals under the cap. Only DACCS should be allowed to be financed in

a first phase, and investments into BioCCS should be contingent on an assessment of the state of, and potential impacts on, the EU's land sink.

## Aviation

- The Commission's proposal to expand the aviation ETS moves in a positive direction (such as integrating private aviation and some departing flights), but does not go far enough. Around 70% of emissions from flights departing the European Economic Area (EEA) would still be exempted from the EU carbon price, while long-haul flights produce around half of Europe's aviation $CO_2$ emissions but account for just 6% of flights.
- Expanding to all departing flights would raise another €6 billion in revenues, while international flight tickets would only increase marginally according to CE Delft.
- Airlines would receive around €13 billion in free ETS allowances through 2040 to support alternative fuels (assuming an average EUA price of €122), potentially even for flights that are not covered by the ETS. In other words, airlines could receive billions in support from public funding while continuing to avoid a carbon price on a huge share of their emissions.

**Policy recommendations:**
→ Include coverage of all departing flights, including the longest and most polluting journeys.
→ Include all business and private flights, with consideration for a price multiplier of four for private flights.
→ Link eligibility to alternative fuels free allowances with coverage through the ETS.
→ Exclude biofuels and steer support to only sustainable and scalable solutions such as electrification.

## Maritime

- Bringing smaller vessels into the EU carbon market and expanding support for zero-emission technologies (including in lower-income third countries) are positive moves forward. But the proposal still leaves important parts of the fleet outside of ETS coverage: only 67% of emissions from smaller vessels will be covered by the EU ETS, and only from 2031.

- Setting aside 900,000 ETS allowances annually until 2035 for maritime decarbonisation in least developed countries (LDCs) and small island developing states (SIDS) is a welcome suggestion but needs to be significantly expanded. The EU should help lower-income and more vulnerable countries chart a cleaner course for their shipping sectors.

**Policy recommendations:**
→ Include all ro-pax and passenger ferries, cruise ships, yachts, bulk carriers, and container ships, as well as all international voyages starting in 2029.
→ Significantly increase the amount of earmarked ETS allowances for maritime decarbonisation in LDCs and SIDS. Set aside at least 1.8 million allowances annually and keep the mechanism till the end of the trading period in 2040.
→ Support only genuinely sustainable, zero-emission solutions such as electric and wind-assisted propulsion - not biomass or "low-carbon" hydrogen and fuels, which can still be fossil-based, or bio-LNG.

## Revenues

- The shift from 100% climate spending to at least 50% sectoral reinvestment in decarbonisation of ETS sectors raises equity concerns as free allocation will be prolonged, while public spending towards adaptation, biodiversity, households and SMEs protection against climate change damages remains overlooked.
- Considering the amount of revenues that is currently channelled back to ETS sectors via indirect cost compensation (already 23% of current auction revenues) and direct funding of projects through the Innovation Fund, Modernisation Fund, and the new IDB, it is essential to ensure other sectors and needs can be covered via ETS revenues (adaptation, clean transport, protection for vulnerable households, biodiversity and international climate finance).

**Policy recommendations:**
→ Encourage EU member states to prioritise emission reductions respecting the 'Do No Significant Harm' principle, and adopt a "people first" approach to fund projects and policies that would directly benefit the lives of communities in the EU and internationally.
→ Get rid of indirect cost compensation or at least include it under the new 50% spending threshold for ETS sectors.

## Waste incineration

- The integration of waste incineration in ETS1 is a welcome step in the right direction, as it corrects the current failure to price emissions from burning municipal waste. But a long phase-in, national opt-outs and free allocation will weaken the carbon price signal and delay the shift away from incineration.
- ETS1 must support waste prevention, reuse and recycling instead of locking Europe into burning waste. Carbon pricing is the right solution to make these options more attractive and help reduce the amount of residual waste.

**Policy recommendations:**
→ Ensure full ETS coverage of municipal and hazardous waste incineration, including fossil and biogenic CO2 and emissions from heat and electricity generation. The proposed national opt-outs should be completely removed. If retained as a compromise, they must require a mandatory equivalent national carbon or waste incineration tax, combined with strict, binding compliance with recycling targets and landfill diversion (comply with all criteria).
→ Eliminate free allocation for waste-to-energy plants and complete the free allocation phase-out for all waste incineration activities by 2034 at the latest.

## For more details on the above items as well as on the zero-rating of biomass and ETS2, find CMW's complete position paper on the ETS review here.

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