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Future of emissions trading in the EU: Coverage Analysis – Launch Event

ERCST, Rue Archimède 61, 1000 Bruxelles

Future of emission trading in the EU

- "Future of emission trading in the EU" project aims to provide original analytical insights, pinpoint challenges, and propose solutions for its evolution during the second Phase of phase IV (2025-2030) and post-Phase IV.
- Project has kicked off in June 2024 and aims at addressing the following issues:
 - Future of emission trading in the EU coverage (*Report launch September 26th 2024*),
 - Role of emission trading in EU climate policy
 - Price signal and competitiveness,
 - Carbon removals,
 - Agriculture,
 - Market functioning,
 - Architecture and governance.

1. Background

- The review of the emission trading system in the EU and how the architecture emerges should there be an expansion, is an issue of increasing urgency. The European Commission has also started its own examination.
- ETS1 has become effective and gained new impetus and is seen as an important tool in the EU decarbonization toolbox. However, there is a need to examine the role and architecture of emission trading in the EU.
- Regulatory markets require policy stability and predictability; we have learnt that it takes time to make these changes and for the markets to adapt.
- We are entering into new territory with the CBAM, the expectation of zero EUAs by 2039 in the ETS1 and the need to have a system that works. The problem of liquidity will emerge, and it is likely that we will see a more unstable market in the mid-30s. The transition to zero EUAs also needs to be managed, including governance. All this require examination.
- This paper examines the areas for potential scope expansion. Where relevant, it will consider the possible merging and linking of the various emission trading under one or several umbrellas, and how their architecture relate to each other.
- Besides sectoral coverage, this paper also considers other scope expansions, including through the inclusion of additional GHGs, negative emissions, geographical EU expansion, as well as international aspects (linking and the use of international credits).

1. Background

Why considering ETS expansion?

- No direct or indirect policies impacting levels of GHG emissions.
- Sectors not reducing GHGs emissions with current policies.
- No EU wide harmonised approach?
- No market approach/ no incentives?
- New targets?
- Improvement of the market functioning?
- Reducing the cost of climate policies.
- The acceptability of climate policies

1. Background

What should be considered in assessing expansion?

1. **‘current status’** describes the state of play of the current situation in terms of size of emissions, installations, current regulations, etc.
2. **‘timeline’** details the expected or anticipated chronology for expansion.
3. **‘scenario’** looks at whether the considered expansion should take place under ETS1, ETS2, a separate emissions trading system in the EU, as well as modalities. They show possible outcomes, considering the status of EU regulation, rather than choosing a likely path. The scenario of merging ETS1 and ETS2 is more speculative, considering that ETS2 has not kicked off yet.
4. **‘impacts on supply/demand balance’** analyzes the impact on demand and supply in the emissions trading system where this new area would be included and implicitly the impact on prices.
5. **‘impacts on market functioning’** analyzes impacts on liquidity, volatility, price discovery, stability, and overall market’ efficiency
6. **‘discussion’** is a section that intends to bring the above considerations together, and include others, in making the case for inclusion or non-inclusion.

2. Outlook – most likely scenario

Sector/ area of expansion	Sub-sector/area of expansion	Likely Emissions Trading System	Likely year of coverage	Likelihood of coverage	Impact on ETS1/ETS2	
					Supply/ demand balance*	Market functioning**
Municipal waste incineration and landfills		ETS1	2028	High	+	+
International aviation	Emissions from extra-EU departing flights	ETS1	2027	Medium/high	-	+
Maritime	100% of international maritime emissions	ETS1	2029	Low	-	0
	Smaller vessels	ETS1	2031	Medium/high	+	+
Smaller energy & industry installations	Small scale energy industries (CRF 1A1) + Small manufacturing industries and construction (CRF 1A2)	ETS2	2027/2028	High	0	0
	Combustion installations below rated thermal input of 20 MW	ETS2	2031	Uncertain	0	0

Notes:

* high downward pressure on prices (++); low downward pressure (+); neutral/no impact (0), low upward pressure on prices (-), high upward pressure on prices (--)

** high positive (++), low positive (+), neutral/no impact (0), low negative (0), -- (high negative)

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Agriculture	Midstream	ETSAg	After 2030	Medium/high	0 (Separate ETS)	0 (Separate ETS)
Non-CO2 emissions in aviation		ETS1	2031	Medium/low	+	+
Negative emissions	CDR technologies (specifically DACCS and BECCS)	ETS1	2031	Medium	+	+
Geographical expansion	e.g. Ukraine	All (depending on timeline)	After 2030	Not an environmental decision	Uncertain	0/+
International linking	Targeted to the UK and EU neighborhood countries	ETS1+ETS2, ETS3 etc	After 2030	Medium (for targeted countries) Low (outside targeted countries)	+	++
International credits	Removals	ETS1 ETS2	After 2030	Medium/high	+	+

Notes:

* high downward pressure on prices (++); low downward pressure (+); neutral/no impact (0), low upward pressure on prices (-), high upward pressure on prices (--)

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3. Take Aways/Recommendations

Municipal waste incineration and landfills (section 2.1.)

- The inclusion of municipal waste incineration in ETS1 in 2028 is a scenario that is likely and makes sense.
- Some aspects that will need to be managed include the interaction along the whole value chain, environmental implications and interlinkages with different EU files, and safeguards to leakage, and cost pass-through mechanisms.

International aviation (section 2.2)

Coverage of international departing flights (rather than departing AND arriving flights) in line with what can be considered as the EU's fair share of emissions. Coverage conditional on no double burden with CORSIA. They could be integrated through two different approaches:

- Extra-EEA departing flights + domestic aviation in a separate emissions trading system
 - Separate system would become the main decarbonisation driver for the sector (at the expense however of efficiency losses with respect to economy-wide emissions reduction)
 - Other measures (e.g. SAF blending quotas) rendered unwarranted.
- Extra-EEA departing flights in ETS1 together with domestic aviation (politically more realistic/viable option)
 - Consider introduction of a limit on the quantity of allowances that airlines can use from the stationary sector, as a way of introducing a hard cap on aviation emissions and inducing greater in-sector emissions reduction.

3. Take Aways/Recommendations

International maritime transport and smaller vessels (section 2.3)

- Maintain the 50% scope with respect to international maritime voyage emissions even in the absence of international progress, as the reduced scope is in line with the EU's fair share of emissions.
- Include smaller vessels after a transitional period, giving relevant stakeholders in the value chain the necessary time.
- Possible inclusion of the maritime sector in a separate emissions trading system in the EU, possibly together with aviation, warrants more assessment.

Smaller energy and industry installations (section 2.4.)

- ERCST sees the inclusion of smaller installations in ETS2, and of installations below 20 MW total rated thermal input threshold as a likely scenario.
- The integration of the first group will depend on the success of the ETS2. ETS2 is a new system to be tested, whose creation was hotly contested.
- The assessment of small installations in ETS2 should be looked at considering their burden. Small installations could require financial schemes and similar carbon leakage provisions to small installations covered by ETS1.

3. Take Aways/Recommendations

Agriculture (section 2.5)

- ETSAg as a separate system is at least an option to be explored. It will be controversial and maybe painful, but if the EU wants to decarbonize by 2050, this is likely the best way, at an EU-wide -level. For political and administrative reasons, a mid-stream application could be the most viable option.
- The impact on farmers of creating an ETSAg should be at the core of the discussion. Competitiveness and carbon leakage will be central. A CBAM to agriculture will test the skills of EU diplomacy in the G77.

Non-CO₂ emissions in aviation (section 3)

- Including non-CO₂ aviation in the EU ETS Directive would at this stage be premature.
- There is still a need for a better understanding, including trade-offs with CO₂.
- Better understanding by the end of the decade, giving at the same time aircraft operators sufficient time to equip aircrafts with the relevant measurement equipment.
- Emissions trading is one of the options. All options, including inter alia operational measures/better routing, improved fuel quality, continuing/expanding support through the Innovation Fund, merit further assessment.

3. Take Aways/Recommendations

Negative emissions (section 4)

- ERCST sees CDR in ETS1 as a solution that warrants exploration and requires a legislative and regulatory framework.
- The technical feasibility and commercial viability of CDR are aspects that will ultimately be determined by its users.
- There is no apparent reason to delay integrating CDR into the current (and future) emissions trading system in the EU.
- Implementation should be gradual, with parallel efforts to enhance CDR's commercial viability through CCfDs. Two equally viable scenarios emerge:
 - i) introduce CDR as a crediting mechanism;
 - ii) incorporate CDR installations into ETS1 coverage while issuing CSU for sequestered carbon.
- The legislative process need not wait until 2026. If CDR proves unviable at scale, either commercially or technologically, this will become evident, and appropriate measures can be taken accordingly.

3. Take Aways/Recommendations

Geographical expansion (section 5)

- ERCST considers the geographical expansion of the emissions trading system in the EU to new jurisdictions, and more specifically the inclusion of Ukraine, offers potential benefits, with unknowns that need to be managed.
- This includes increased market liquidity, international alignment with EU climate policies, and opportunities for exporting green technologies.
- Key concerns include the lack of data from Ukraine, the inexperience with carbon markets, the repercussions of agriculture, the geopolitical uncertainty, the post war-economic conditions and social impacts.

International linking and use of international credits (section 6)

- ERCST sees international expansion as a necessity, with the only caveat being which sub-scenarios become necessary to ensure that the ETS delivers the objectives of the Climate Law, with minimal need for additional regulatory constraints and that it has political buy-in.
- In light of this, removals, with a strong SDG component, and some price control mechanism that will ensure that there is no strong deviation from EUA prices, will be seen as necessary.