

EU ETS Review:

EC PROPOSAL VS DRAFT ENVI REPORT

Andrei Marcu, ERCST

Juan Fernando López, ERCST

Thomas Mertens, ERCST

Anita Ruth Vollmer, ERCST

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1. Introduction

As one of the most important climate policy tools in the European Union (EU), the EU Emissions Trading System (ETS) and its revision are crucial to the Fit for 55 Package published by the European Commission (EC) in July 2021. The EC's proposal touches upon key elements of the EU ETS that were described in a previous paper by ERCST¹.

In January 2022, the ENVI committee in the European Parliament (EP), and more specifically the ENVI rapporteur, published its draft report that includes several amendments to the proposal of the Commission. This paper aims to compare the ENVI draft report with the Commission proposal to identify key issues that could take centre stage in the EP discussions involving the following trilogue negotiations.

For each issue identified this paper will include a brief description of the issue, a comparison of the ENVI draft report and Commission proposal, and an analysis by ERCST.

2. Key issues

2.1. Free allocation and CBAM

Summary

The purpose of free allocation in the EU ETS is to avoid carbon leakage. The EC has updated the rules for free allocation during the last 2 ETS compliance periods to better address the risks of carbon leakage and at the same time avoid windfall profits.

However, in the Fit for 55 Package, the Commission introduced a novel policy measure to address the risk of carbon leakage, namely a Carbon Border Adjustment Mechanism (CBAM). Even though designing the CBAM is a separate process from the EU ETS revision, there is a recognition that CBAM is deeply interlinked with the EU ETS.

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
Free allocation	- Option of transitional free allocation for modernisation of energy sector needs to be removed. - Introduction of a bonus-malus system & conditionality on climate neutrality	12 13, 51 15, 53, 54 55	- Free allocation for CBAM sectors phased out by 2035. - Max update rate of benchmarks to 2.5% as of 2026, up from current 1.6%.

¹ Bloomberg & ERCST (2021): "The Commission Proposal on the ETS Review: A Cool-Headed Assessment". Available at: <https://ercst.org/wp-content/uploads/2021/09/20210914-Final-Paper-1-2.pdf>. Accessed on 28 January 2021.

	plans (sectoral roadmaps) instead of conditionality on energy audits.		- Conditionality on implementation of measures in energy audits.
	- Temporary CBAM reserve with rolling review mechanism.		

The Commission proposal introduces a CBAM for iron & steel, aluminium, cement, certain fertilizers, and electricity sectors. These sectors would have a 10-year transition period in which free allocation is gradually phased out at 10% per year, starting in 2026. To support them to further decarbonise, allowances that would otherwise go to free allocation would be sent to the Innovation Fund.

The ENVI draft report does not propose any major amendments to the Commission proposal on phasing out free allocation in CBAM sectors, except in terms of what should happen with the allowances otherwise going to free allocation in these sectors. Instead of sending them to the Innovation Fund, the draft report proposes to keep these allowances in a temporary CBAM reserve with a review mechanism.

Another consideration for free allocation has been to avoid the application of the cross-sectoral correction factor (CSCF). In this regard, the Commission proposes to increase the maximum adjustment of the benchmark values from 1,6% to 2,5% per year to better reflect technological progress. In addition, free allocation would become conditional for installations which would have the obligation to conduct an energy audit. They would be required to implement cost-effective measures of the audit report or risk losing 25% of free allocation starting in 2026.

The ENVI draft report proposes a considerably different approach by introducing a bonus-malus system. According to this system, installations with emissions above the 10% best installations will lose up to 25% of free allocation if no climate-neutrality plan has been established or if the milestones and targets in the installation's climate-neutrality plan have not been attained. Installations whose GHG emission levels are under the 10% best performers, in 2021 and 2022, may receive up to 10% of additional free allocation at the benchmark value.

Analysis

As stated before, the CBAM is a novel tool that has not been tested or implemented before. Introducing such an approach without having any safeguards or mechanisms to address potential failure can be seen as unnecessarily risky. The proposed amendment of the ENVI committee to introduce a temporary reserve with a review mechanism addresses these potential risks to some degree. This way, the transition from free allocation to CBAM could be implemented while further measures could be taken depending on the effectiveness of the CBAM to prevent carbon leakage. However, any discussion of these issues must remain highly speculative so long as key questions, e.g., on the role of exports, remain unsettled in the development of the CBAM.

The bonus free allocation proposal will impact the signal for safeguarding core ETS principles. These include avoiding abuse of carbon leakage instrument for incentivisation purposes, removing the principle of equivalent protection for each sector participant, impacting free choice for installations between reducing emissions or procuring allowances, introducing an expectation of climate neutrality for each individual

plant versus the ETS-wide common cap perspective, and channeling additional (free) allowances to a small minority or actors. Abandoning ETS basic principles will not provide regulatory certainty and transparency into the system.

2.2. Market Stability Reserve (MSR)

Summary

The MSR was initially introduced to address the historical surplus of allowances. In addition, the MSR aims to address future build-up of surplus due to unforeseen shocks, such as the 2007-2008 financial crisis, as well as other factors that would lead to a surplus in the EU ETS.

The current design of the MSR can be considered problematic on several issues. First, the high intake rate of 24% is associated with bumpy carbon price pathways, which is not helpful for planning decarbonisation efforts². Second, the static nature of the intake rate leads to uncertainty related to the MSR threshold effect.

Finally, the invalidation mechanism leads the MSR to deviate from its initial purpose as it becomes a tool that impacts the ambition of the overall ETS. To maintain the trust of market participants, the ambition of the ETS should be set through more transparent ways such as the cap and the Linear Reduction Factor (LRF).

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
Market Stability Reserve (MSR)	To avoid CSCF, variable back-up of share of MSR allowances that would otherwise be invalidated.	30 58	- 24% intake rate maintained until 2030. - Buffer intake rate. - Allowances in MSR above 400 million will be cancelled. - Total Number of Allowances in Circulation (TNAC) calculations would include aviation.

The Commission proposes to maintain the 24% intake rate until 2030 but introduces a buffer intake rate when the TNAC is between 833 million and 1096 million. If the TNAC is between those thresholds, the intake will be limited to the difference between the TNAC and 833 million.

Furthermore, the Commission proposes to invalidate allowances kept in the MSR above 400 million based on previous year volumes, as well as include net demand from aviation and maritime in the TNAC calculations.

² <https://ercst.org/wp-content/uploads/2021/09/20210914-Final-Paper-1-2.pdf>

The ENVI draft report does not propose major changes to the Commission proposal when it comes to the functioning of the MSR. However, an amendment is proposed to the invalidation clause where instead of invalidating allowances, they are kept in a variable back-up that can be used to mitigate the risk of a potential CSCF.

Analysis

The ENVI draft report seems to support the proposed amendments to the functioning of the MSR and the proposed approach of the Commission. It indicates that the rapporteur recognises the role of the MSR to address the historic surplus and potential future surpluses in a timely manner, as well as the issue of the threshold effect and the related uncertainty if the high intake rate is maintained.

On the other hand, the rapporteur does not fully address the concerns related to the invalidation clause but instead opts to use the MSR as a tool to address the risk of triggering the CSCF.

2.3. Modernisation Fund

Summary

The Modernisation Fund was introduced to help finance the modernisation of the energy systems of ten Central and Eastern European Member States, as well as finance improvements in energy efficiency in those countries. The initial size of the Modernisation Fund was estimated to cover 3-9% of additional investment needs associated with the 2030 climate and energy framework³.

While the Modernisation Fund cannot be expected to be solely responsible for ensuring modernisation of the energy system in the eligible Member States, the increased overall ambition of the EU, including the updated 2030 target, warrants an increase of the current size to help facilitate and speed up the modernisation process. It also shows solidarity with those Member States where the transition is especially challenging.

In addition, at least 70% of the funds must be spent on the priority investments under Art 10d (2) with less strict spending rules applied to the remaining 30%.

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
Modernisation Fund (MF)	- Transfer 50% of the proposed MF top-up to projects under the Innovation Fund. - Member States may use transitional free allowances (Art 10c), not being allocated to operators by 31 December 2023, to	46, 59 66 67	- Additional 2.5% of the cap is auctioned to increase MF.

³ <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52014SC0015>

	support investments within the framework of the MF (10d). - Should not support nuclear.		- MF cannot finance investments in any type of FF.
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The Commission proposes to increase the size of the Modernisation Fund by auctioning an additional 2,5% of the cap to cater to additional funding needs related to the higher EU climate ambition. Furthermore, the Commission proposal would ensure that investments through the Modernisation Fund will not harm the objectives of the European Green Deal by prohibiting the funds to support investments in any type of fossil fuel while also increasing the percentage of the fund that needs to go to priority investments to 80%.

The ENVI draft report looks to balance the topping up of funding to the Innovation Fund as well as the Modernisation Fund by splitting the 2,5% into two equal parts. In addition, the draft report proposes to end transitional free allocation for the power sector under Art 10c. Instead, the Member States involved may use these allowances to support investments within the framework of the Modernisation Fund or any other purpose in line with the EU ETS Directive.

Another important amendment proposed by the rapporteur is to exclude funding for investments in nuclear energy.

Analysis

While the Modernisation Fund may be an efficient tool to address the transformation of the energy system in some specific Member States (i.e., those with a GDP per capita below 60 % of the Union average in 2013), the Innovation Fund aims to support specific projects across the EU on an equal basis for all Member States. Strengthening the role of the Innovation Fund therefore looks like an accepted way forward. As Member States may also use transitional free allowances from free allocation for the modernisation of the energy sector, the role of the Modernisation Fund shall in principle not be undermined.

Another pending issue is banning the support of nuclear under the MF. It is necessary to consider that nuclear does not produce direct carbon dioxide emissions and is therefore important especially under the current shortage of gas supply and increased energy prices.

2.4. Innovation Fund

Summary

The Innovation Fund was introduced to support investments for the demonstration of innovative low-carbon technologies in energy intensive industries, renewables, energy storage and carbon capture and usage. The first calls for proposals in 2020 have shown that there is a large interest from project developers, as well as a high need for support that can be provided through the Innovation Fund.

In the first call for proposals, a total of €21.7 billion for large-scale projects and €1 billion for small-scale projects was requested. However, for these two calls only €1.1 billion was available. Moreover, at current market prices, the Innovation Fund is 'only' expected to provide around €18 billion in financing over Phase

4, which is already insufficient to cover the requested amounts of the first call for proposals. Given that this interest will only increase over time, it is important to reconsider the size of the Innovation Fund.

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
Innovation Fund (IF)	- If CBAM is effective in avoiding carbon leakage, allowances in the CBAM reserve should be auctioned and proceeds should be added to the Innovation Fund. - Should not support nuclear. - Should support agriculture, aviation and transport also. - At least 10% for railway systems and local public transport	17 62 63	- 200 mln allowances added, 150 from ETS 2. - Scope includes project support via CCfDs.

In the Commission proposal, the size of the Innovation Fund is increased by adding 200 million allowances, of which 150 million will come from the ETS for road transport and building. In addition, to leverage the funds in the Innovation Fund, the scope is extended to include project support via Carbon Contracts for Difference (CCfDs).

As discussed under the Modernisation Fund, the ENVI draft report maintains that the top up of 2,5% of the cap should be equally divided between the Modernisation Fund and the Innovation Fund. In addition, allowances kept in the CBAM reserve should be auctioned and proceeds added to the Innovation Fund if an assessment indicates that the CBAM has been effective in avoiding carbon leakage.

Lastly, the ENVI draft report also introduces amendments to direct a predetermined share of 10% of funds towards railway systems and local public transportation. Further amendments to target specific sectors include support for agriculture, aviation and transportation, as well as excluding funding for nuclear energy.

Analysis

The Innovation Fund is working. As such, it may be one of the tools ensuring the success of the EU's decarbonisation from here to 2050. Usually underestimated, the Innovation Fund may play a material role in the years to come and therefore the size and scope shall be further expanded.

This is even more important considering the last call for both small and large-scale projects with a high number of applicants.

An expansion of the Innovation Fund may ensure that CCU and CCS technologies are implemented. It may provide the incentive that the current carbon price does not provide to front runners. Setting a CBAM reserve conditional on carbon leakage protection of CBAM sectors, may however decrease the final amount

destined to the IF. Increasing the size of the IF shall be a main priority and not dependent on maintaining the same level of carbon leakage protection under the CBAM⁴.

The IF can have an impact in helping navigate competitiveness and carbon leakage in the long term. Still there is clearly a degree of separation, it at best an indirect tool.

2.5. ETS extension to maritime

Summary

The EU wants to include maritime transport activities under the current EU ETS. As no final international agreement through the IMO (International Maritime Organisation) has been achieved so far, the EC proposes to set surrendering obligations for the CO₂ emitted by maritime transport. Some elements are currently under discussion, for instance when maritime transport shall enter into the EU ETS, or the percentage of emissions to be covered by this scheme. The European Parliament proposal to create a single Ocean Fund, independent from the EU Innovation Fund, may also trigger additional debate during the following months.

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
ETS extension maritime	- If global measures at IMO level are adopted and at least comparable to EU measures, the scope of ETS should be reduced, if not, the scope should be extended to 100%. - Move forward date of full application to 2025. - Include methane emissions, not only CO₂. - Establish an Ocean Fund	8 6 5 10, 41	- All emissions from intra-EU, 50% from extra-EU and at berth in EU port - As of 2026, shipping companies must surrender 100% of their emissions

- European Commission proposal.

On 14 July 2021 the EC proposed to include CO₂ emissions coming from the maritime sector into the current EU ETS. As such, as from 2026, the EU ETS may include maritime transport activities of ships covered by

⁴ According to the amendments proposed in the ENVI Draft Report, the reduction of free allocation for CBAM sectors and released from the Carbon Leakage Protection Reserve pursuant to Article 10a(1b), third subparagraph, shall be made available for the Innovation Fund. This scenario will happen only if the carbon leakage protection of the CBAM sectors is not undermined due to the application of CBAM. However, if the carbon leakage protection of CBAM sectors is undermined due to the application of a CBAM, the free allocation from CBAM sectors, otherwise to be sent to the IF, will not be transferred to the Innovation Fund.

Regulation (EU) 2015/757⁵ performing voyages with the purpose of transporting passengers or cargo for commercial purposes⁶. The monitoring of CO₂ emissions of the maritime sector is already in place under the EU Monitoring, Reporting & Verification (MRV), but pending an international agreement through the IMO, the EC proposes CO₂ compliance obligations for shipping companies. For voyages within the EU, the reporting requirements would be 100% of the CO₂ emitted, while for ships' voyages between a port within the EU and one outside the EU, it will be 50%. Maritime transport shall follow similar compliance obligations (and penalties, if any) as other operators and aircraft operators, under the current EU ETS⁷.

According to the EC proposal, shipping companies shall be liable to surrender allowances in a progressive way, thus 20% of their verified emissions as reported for 2023, 45% as reported by 2024, 70% as from 2025, and full surrendering as from 2026 and thereafter. Due to the inclusion of maritime, the Union-wide quantity of allowances shall be increased by 79 million allowances for maritime transport.

- Draft Report from ENVI.

With respect to the maritime extension, the ENVI Draft Rapporteur aims to increase the ambition of the EC proposal. Not only would he include international maritime transport under the current extension (thus reporting requirements of 100% of the CO₂ emitted for international voyages) if there is no IMO agreement, but it would also call for the inclusion of methane Emissions (CH₄). A more gradual phase-in requirement for ice-class ships⁸ is also considered due to an expected higher fuel consumption. In addition, ENVI proposes to move the full surrendering of CO₂ emissions for maritime up by one year, which otherwise would take place in 2026. This shall generate an additional 57 million allowances.

According to the ENVI draft proposal, commercial operators shall be liable to surrender allowances in the following way: 33.3% (instead of 20% proposed by the EC) of their verified emissions as reported for 2023,

⁵ Regulation (EU) 2015/757 of the European Parliament and of the Council of 29 April 2015 on the monitoring, reporting and verification of carbon dioxide emissions from maritime transport, and amending Directive 2009/16/EC

⁶ Regulation (EU) 2015/757 applies to ships above 5 000 gross tonnage in respect of CO₂ emissions released during their voyages from their last port of call to a port of call under the jurisdiction of a Member State and from a port of call under the jurisdiction of a Member State to their next port of call, as well as within ports of call under the jurisdiction of a Member State. It does not apply to warships, naval auxiliaries, fish-catching or fish-processing ships, wooden ships of a primitive build, ships not propelled by mechanical means, or government ships used for non-commercial purposes.

⁷ In the case of a shipping company failing to comply with surrender requirements for 2 or more consecutive reporting periods, the competent authority of the Member State of the port of entry may issue an expulsion. As a result, every Member State, with the exception of the Member State whose flag the ship is flying, shall refuse entry of the ships into any of its ports until the company fulfils its surrender obligations. (Art 11a of the EC proposal)

⁸ No definition is given of ice-class ships under the ENVI Draft Report. Instead, the Commission shall adopt implementing acts to establish detailed rules relating to the identification of vessel's ice class or navigation in ice. (Amendment 38 of ENVI Draft Report).

66% (instead of 45%) as reported by 2024, 100% (instead of 70%) by 2025. Due to the inclusion of maritime, the Union-wide quantity of allowances shall be increased by up to 79 million allowances.

Special consideration is required for the proposal for an Ocean Fund aiming to improve the energy efficiency of ships and ports, and the deployment of sustainable alternative fuels. This fund shall be generated from two sources: 1) revenues generated from the auctioning of allowances in the maritime ETS and 2) penalties paid under the Fuel EU Maritime regulation to be adopted under the Fit for 55 Package.

Analysis

ENVI's amendments regarding maritime activities may be justified based on the objectives they seek. Including maritime transport under the EU ETS a year sooner shall introduce additional allowances thus creating a barrier for the application of a CSCF. In the EC impact assessment of the EU ETS, the EC has showed its willingness to avoid the application of the CSCF, while some analysis show it may be triggered by 2028.

While we may think that the maritime sector is not yet ready for the challenge and that 2025 is too soon, it must be recalled that monitoring CO₂ emission from maritime transport has been in place since 2015. The maritime sector cannot be compared with the road transport and building sectors, neither in terms of CO₂ accounting, for which monitoring rules are already in place, nor in terms of readiness for implementation. The impact of the independent Ocean Fund is still uncertain. While the Innovation Fund can contribute in the long term to support the decarbonisation of hard to abate sectors, a new single fund may add an additional administrative burden and complexity to the system. Still the consequences of setting an independent Ocean Fund are uncertain at the current state.

2.6. New ETS for road transport and buildings

Summary

The EC has also proposed the creation of a new ETS system for road transport and building. While they will remain also regulated under the Effort Sharing Regulation (ESR), through national targets, this as first step to set a European carbon market for these sectors. Still the consequences of its implementation are uncertain the new ETS would operate in an independent manner with the objective to be merged with the current EU ETS at a future date, still to be determined. The extension of the ETS to road building and transport may impact poor households and social considerations will play a role within the upcoming EU negotiation process. The new ETS is a sensitive topic with social impact and may undermine the success of the full EU ETS revision if not addressed in the right way.

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
New ETS for road transport and buildings	- Should cover all fuels to ensure level playing field. - Applicable as of 2025 instead of 2026, with opt-out clause until 2027 for private road transport and residential building heating.	19	- Cap will be set from 2026, alongside LRF in line with 43% emission reductions by 2030. - Includes price-based cost-containment mechanism. - Separate MSR for both sectors operational as of 2027.

- European Commission proposal.

On 14th of July, the EC called for the creation of an independent ETS for road transport and buildings. Despite some voices calling for these sectors to be included under the current EU ETS, the ETS for road and transport (so called also “ETS 2”) would start in 2026 as an independent system aiming to be merged in the long term with the on-going ETS. Setting surrendering requirements to on fuel supplier, the new ETS would cover fuels used in buildings and road transport, notably (a) Combined Heat and Power Generation (CHP) and Heat Plants, (b) Road Transportation (excluding the use of agricultural vehicles on paved roads), (c) emissions from fuel combustion in commercial and institutional buildings, and (d) all emissions from fuel combustion in households.

While no free allocation would be provided in this ETS, the EC is proposing a LRF of 5.15% starting in 2024 based on the average reported emissions for the years 2024, 2025 and 2026. Allowances covered by the ETS2 shall be auctioned separately from the EU ETS, where 600 million allowances are to be created and held in a separate MSR.

- Draft Report from ENVI.

The Rapporteur has recently proposed to extend the scope of the ETS beyond road transport and buildings. Not only the draft calls for extending the scope to other fuels (including process heating in smaller installations), but also to bring one year forward its implementation (2025 instead of 2026), while introducing an opt-out clause until 2027 for fuels for private road transport and residential building heating. The reporting for the new ETS would start during 2023 and 2024 (rather than 2024 and 2025 as proposed by the EC). The temporary opt-out clause would provide Member States the possibility to delay the application of emissions trading until 2027. Member States that use the opt-out will have to prove that they can meet their emissions-cutting targets.

In addition, ENVI Draft Report is proposing to extend the scope to all types of fuels (not only from buildings and road transport) for the new ETS to be effective and now. The definition of 'fuels' concerned shall include all relevant activities. Railways and local public transports, as environment friendly modes of transport, would be also further incentivised with a specific 10% dedicated funding under the Innovation

Fund. 25 % of the total quantity of allowances covered by these sectors shall be auctioned and the revenues generated allocated to the Social Climate Fund.

Analysis

Being a sensitive topic due to its social expected impact, there is no consensus on the new ETS for road transport and buildings among EU policy makers. Even if the EC proposal would require Member States to use a part of their auction revenues generated to address social aspects of the ETS with a specific emphasis on vulnerable households, vulnerable micro-enterprises and vulnerable transport users, some concerns remain. To highlight, the new ETS could have an undesirable negative impact on the energy bill and poor households. Even if the Social Climate Fund aims to bridge the gap of setting an additional regulatory burden for these sectors, it is not clear the public acceptance of this decision. As the EC proposal progresses through the legislative process, the input of the Council on this file will be key.

2.7. *Municipal Waste Incineration*

Summary

ENVI has proposed the inclusion of municipal waste incineration under the current EU ETS Directive. If the amendments are approved in the final text, the EC would be requested to undertake an impact assessment of the consequences of including municipal waste incineration under the EU ETS scope. Pending EC assessment by 2025, municipal waste would be included under the EU ETS scope by 2028 at the earliest.

Comparison

Municipal waste incineration	- By 31 December 2025, EC report to European Parliament and Council to evaluate the inclusion of municipal waste incineration installations in the EU ETS. - If positive, inclusion as from 1 January 2028.	44	
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- European Commission proposal.

The EC proposal did not include any modification of the current framework for municipal waste incineration. The only reference to municipal waste is given under Annex I⁹ of the ETS Directive as “Combustion of fuels in installations with a total rated thermal input exceeding 20 MW (except in installations for the incineration of hazardous or municipal waste)”. Therefore, we can find an explicit provision excluding this type of fuels from the ETS Directive scope. We can still find more information about the EU approach regarding municipal waste under the Guidance on Interpretation of Annex I of the EU ETS

⁹ Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (Text with EEA relevance)

Directive, which states that “it is for the competent authority to determine whether a particular installation falls into one of these categories taking account the relevant definitions in the WID (Waste Incineration Directive)”¹⁰. Up to now, the Waste Incineration Directive and not the EU ETS is the policy file regulating municipal waste.

- ENVI Draft Report.

ENVI amendments regarding municipal waste are a new element under the EU ETS scope. They fall under the basic principle that in the end all EU CO₂ emissions shall be covered by a common carbon market. ENVI recognises that including municipal waste incineration under the EU ETS may trigger a potential large-scale redirection of waste from municipal waste incineration installations towards landfills in the Union, which creates methane emissions, and potentially exports to third countries, with a potentially hazardous impact on the environment. It is for this reason, that municipal waste incineration would be included by 2028 in the EU ETS, at the earliest, and as long as it is preceded by a positive impact assessment in 2025.

The inclusion of municipal waste incineration would trigger additional allowances into the EU ETS from January 2028, with the exact amount to be determined through implementing acts.

Analysis

ENVI’s proposal for the inclusion of municipal waste looks reasonable considering the EU objective of a net zero economy by 2050. However, it is challenging to anticipate the impact of this substantial modification of the EU ETS scope.

While “including incineration in the EU ETS could save as much as 8.8 MtCO₂ a year by 2030 by incentivising additional recycling by households and companies”¹¹, there are some concerns of including emission from waste incineration under the EU ETS, as regarding potential leakages to landfill activities and waste export outside of the EU. Notwithstanding, the fact that Germany for which from 2023 is set to include incineration in its national carbon pricing mechanism, may incentive Germany waste exports to other EU countries, thus setting pressure on the EU to take a decision on this.

Broadly, one can argue these arguments have been somewhat overtaken by developments and in general the benefits will outweigh the risks.

¹⁰ European Commission (2010): “Guidance on Interpretation of Annex I of the EU ETS Directive”. Pp 13.

¹¹ Manuell, R. (2022): *ANALYSIS: Trash talk – Adding waste incinerators to the EU carbon market*. Carbon Pulse. 7 February.

2.8. CSCF

Summary

One important concern that is reflected both in the Commission proposal and the ENVI draft report is the high possibility of triggering the cross-sectoral correction factor (CSCF), considering the more ambitious cap.

Various studies have been conducted to estimate when the CSCF would be triggered and while the exact date varies, there is a possibility that this will occur in 2026-2028¹². Different sector associations and compliance actors have expressed concerns regarding the CSCF and the uncertainty that it brings for future free allocation.

Comparison

Core elements	ENVI draft report	Amendment	Commission proposal
Cross-sectoral correction factor (CSCF)	Further strengthening its avoidance. - +57 million allowances bringing maritime into EU ETS from 2026 to 2025. - +12 million allowances phasing out free allocation faster from aviation sector (from 2027 to 2026). - Using allowances otherwise invalidated from the MSR.	6 30 34-36 37 39 56-57	- Max update rate of benchmarks to 2.5% as of 2026, up from current 1.6% - Conditionality on implementation of measures in energy audits

The proposed approach of the Commission to increase the maximum update rate to 2,5 % per year as of 2026 instead of the current 1,6 %¹³, because of a higher shortage of free allocation, would increase the risk of triggering the CSCF. In addition, the Commission proposes to make free allocation conditional on decarbonisation efforts by requiring installation to implement the recommendations of the energy audit under the current Article 8(4) of the Energy Efficiency Directive or risk losing 25% of their free allocation.

¹² EC (2020). Impact Assessment Report Accompanying the document Amending Directive 2003/87/EC Establishing a System for Greenhouse Gas Emission Allowance Trading Within the Union, Decision (EU) 2015/1814 Concerning the establishment and operation of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Regulation (Eu) 2015/757. Annex 4. Table 54: Impacts of a 70% auction share on free allocation for different cap trajectory options. Pp8. Available at: https://eur-lex.europa.eu/resource.html?uri=cellar:7b89687a-eec6-11eb-a71c-01aa75ed71a1.0001.01/DOC_4&format=PDF (Accessed on 1 February 2021).

¹³ According to the current Art 10a (2) of the EU ETS Directive, as regarding the benchmark values for free allocation, where the annual reduction rate exceeds 1,6 % or is below 0,2 %, the benchmark values for the period from 2021 to 2025 shall be the benchmark values applicable in the period from 2013 to 2020 reduced by whichever of those two percentage rates is relevant, in respect of each year between 2008 and 2023. The EC is now proposing to increase the maximum benchmark reduction rate (1.6%) up to 2.5%, for the period from 2026 to 2030.

The ENVI draft report introduces a bonus-malus system for determining the share of free allocation, as well as climate neutrality plans to installations aligned with sectoral roadmaps instead of the conditionality based on the energy audit. In addition, transitional free allocation for the power sector under Article 10c would be ended. To reduce the risk of triggering the CSCF, the ENVI Draft report proposed other measures such as changing the date of inclusion of the maritime sector to 2025 instead of 2026, moving up the date of phasing out free allocation in the aviation sector from 2027 to 2026, and the variable back-up of share of MSR allowances that would otherwise be invalidated.

Analysis

While there is general agreement that avoiding the application of the CSCF is desired, the proposed approach on how to achieve this differs. The idea behind avoiding the CSCF is to ensure predictability for operators and avoid disincentivising best-performers and innovation. This would avoid additional and unforeseen costs and would provide further incentives GHG reductions to lower the number of allowances needed by installations to comply with the EU ETS.

According to ENVI's draft report¹⁴, avoiding the CSCF requires around 120 million allowances until 2030. Changing the date of the inclusion of maritime and the phasing out of free allocation in aviation is estimated to provide around 69 million allowances for this purpose. The remaining 51 million allowances need to be generated through other amendments proposed which are highly uncertain to lead to the preferred outcome. Therefore, it is important to further conduct studies to estimate the impact of the proposed measures to avoid the application of the CSCF.

2.9. CCSU and negative emissions

Summary

The recognition of both Carbon Capture and Storage (CCS) and Carbon Capture and Utilisation (CCU) is not a new topic of the debate under the ETS. While the current climate framework already sets some incentives for the development of these tools, the 2050 climate neutrality objective set by the European Climate Law has brought the topic back. There is no doubt that CCSU technologies are needed to achieve carbon negative emissions but under the current carbon price, the incentives may not be enough. A partial recognition of these technologies, either through additional free allocation or a reduction of surrendering obligations is currently under discussion.

¹⁴ Liese, P. (2021): Draft Report on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC and operation of a market stability reserve. European Parliament. Regulation (EU), 757.

Comparison

CCUS and negative emissions	- + Additional free allowances when CO ₂ permanently removed through BECCS, DAC and permanently chemically bound.	2-3	- Exemption for CCU which is permanently chemically bound in a product. - Implementing act to decide when a product is permanently chemically bound.
	- Reduced surrendering obligations for chemically bound, LCA based.	62	
	- By 2030, CCU emission accounting system should be reviewed aiming to move the counting of emissions to the point of release into the atmosphere. - Delegated act to decide when a product is permanently chemically bound.	71	

- European Commission proposal.

An important element of the EC proposal is setting the first steps for a framework, under the ETS Directive, enabling carbon dioxide removals (CDR) of CO₂ emissions. In its recital 40, the EC proposed that when CO₂ is not emitted in the atmosphere but re-utilised and permanently chemically embedded in a product, the installation shall not surrender EUAs. The conditions for the accounting of the removals of CO₂ shall be determined by a potential Carbon Removal Certification Mechanism (CRC-M) to be implemented by 2023.

- ENVI Draft proposal.

The proposal of ENVI goes further, and it not only envisages a framework for when CO₂ is permanently chemically bound in a product, but also when CO₂ is emitted later at some point in the value chain. With respect to CCS, the rapporteur proposes additional free allocation when installations make use of Bioenergy Carbon Capture and Storage (BECCS) and Direct Air Capture (DAC) techniques. We can also observe the importance given by the European Parliament to this framework, notably under the proposal to determine when a product is chemically bound through delegated acts and not implementing act, as initially proposed by the EC.

Analysis

The Shaeferkalk court case set a precedent when the European Court of Justice explicitly recognised Precipitated Calcium Carbonate (PCC) as an example of CO₂ chemically bound embedded in a product and thus non-emitted into the atmosphere. Under the current article 49 of the Monitoring and Reporting Regulation (MRR) a captured installation for the purpose of transport and long-term geological storage also enjoys as similar recognition. There is a consensus between the European Commission and the amendments of ENVI to further extend the principle to all CO₂ which is embedded permanently in a product, as not emitted.

The willingness of ENVI to create a framework incentivising both CCU and CCS is not a surprise to us. While the Draft European Parliament Legislative Resolution called for further incentives for the deployment of CCU under the previous revisions of the EU ETS Directive in 2015 (recital 10)¹⁵, ENVI now comes with concrete amendments to be included in a potential revision. From our perspective, it makes sense that when the CO₂ is not emitted, it shall not trigger surrendering obligations. Still an issue remains: at which point of the value chain the CO₂ shall be accounted as not emitted.

Following the rationale of ENVI Draft report's¹⁶ in a next step the CCU emission accounting system should be reviewed with the objective to move the counting of emissions to the point of release into the atmosphere. The EC upcoming EC proposal on Carbon Removal Certification Mechanism (CRC-M) may look further into this issue.

As regarding CCS, ENVI Draft amendments shall incentivise the deployment of BECCS and DACs techniques. While some analysts stating that “prices will have to rise to levels in the region of €130/tCO₂ to incentivise BECCS and reach even higher levels for DAC with carbon storage to be deployed¹⁷” setting additional incentives, , may be perceived as a first step for setting a framework of negative carbon emissions still to be developed.

One approach that should be considered is setting carbon storage obligations (CSO) that would require a percentage of emissions to be captured and stored. This concept may include the creation of carbon storage units (CSU) that will be used to meet CSOs, as well as, at the right price level, EU ETS obligations at some future time – maybe not so far in the future considering the current price of EUAs.

¹⁵ “(10) The main long-term incentive from this Directive for carbon capture and storage (CCS) and carbon capture and use (CCU), new renewable energy technologies and breakthrough innovation in low-carbon technologies and processes is the carbon price signal it creates and that allowances will not need to be surrendered for CO₂ emissions which are permanently stored or avoided.” European Parliament Report on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments (COM (2015)0337 – C8-0190/2015 – 2015/0148(COD)). Available at: https://www.europarl.europa.eu/doceo/document/A-8-2017-0003_EN.html# (Accessed on 8 February 2022)

¹⁶ ENVI Draft Report on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC and Regulation (EU) 2015/757 (COM (2021)0551 - C9-0318/2021 - 2021/0211(COD)). Pp 69. Available at: https://www.europarl.europa.eu/doceo/document/ENVI-PR-703068_EN.html (Accessed on 8 February 2022).

¹⁷ Monahan K. (2022): “Room for removals? Integrating direct air capture into the EU ETS”. Carbon Pulse. 27 January.

3. Missing issues

3.1. Article 29 a.

On 31 January 2021, the EC carbon price reached 100.64 euros/tons of CO₂¹⁸. One year before, in January 2021, the carbon price was 33.90 euros/tons of CO₂, while in January 2018 did not even reach 9 euros. The CO₂ price is internalised by EU ETS and thus the higher the CO₂ price, the higher the cost of compliance. This rapid price increase, together with the current energy crisis, has triggered attention about the possibility of revising the Article 29a. Under the current EU ETS Directive, in the case of excessive price fluctuations, the Art 29a provides the possibility to trigger a cost containment mechanism.

Art 29a has never been triggered and its current wording is unclear as to when it would be triggered and what would be the caution if triggered. In today's market dynamics that is not acceptable uncertainty, as well as unnecessary. It is urgent that the wording and provisions of 29 a be clarified under the EU ETS revision that is being undertaken

The EU ETS Directive recognises a situation of excessive price fluctuations happening when the carbon price is more than three times the average price of allowances during the two preceding years on the European carbon market. If this occurs and the price fluctuations does not correspond to market fundamentals, the authorities may authorise Member States to either bring additional carbon auctioning volumes into the market and to auction up to 25 % of the remaining allowances in the new entrants reserve (NER). So far, the Article 29a has not been triggered, while a political reaction by the EC took place in 2021.

Indeed, we may consider the EC Communication on "Tackling rising energy prices: a toolbox for action and support"¹⁹ as a reaction to the public opinion to trigger this article. At this moment, the EC highlighted that there is no evidence in recent market information that "speculation is a major driver of the price in the carbon market" (pp.12), nor that carbon prices are the significant factor in the energy price spike.

The EC has asked the European Stability Market Authority (ESMA) to investigate any possible anti-competitive behavior in the energy market and to further enhance the monitoring of developments in the carbon market.

ESMA's preliminary report on the Carbon Market, released on 18 November 2021²⁰ has so far not found evidence of a significant change in the breakdown of open positions between the various categories of

¹⁸ ICE. ENDEX (2022): EUA Futures. 5-year future price contract. Available at: <https://www.theice.com/products/197/EUA-Futures/data?marketId=6817108&span=3> (Accessed on 7 February 2021).

¹⁹ COM (2021) 660 final.

²⁰ ESMA (2021): Preliminary report on emission allowances and derivatives thereof". 15 November. Available at: https://www.esma.europa.eu/sites/default/files/library/esma70-445-7_preliminary_report_on_emission_allowances.pdf (Accessed on 7 February 2022)

counterparties since 2018. A final ESMA report will have been announced by the end of the first quarter of 2021.

Under this context, neither the European Commission nor the Parliament have proposed so far any amendments to the current version of the Art29a. A clear definition of “changing market fundamentals”, considering that this is a subjective concept, may be desirable under the upcoming negotiation process.

UK ETS & CCM.

The United Kingdom (UK) ETS replaced the UK’s participation in the EU ETS on since 1st January 2021. While the UK as followed a similar approach as from the EU-ETS, covering Energy Intensive Industries (EIs), the power generation sector and aviation²¹, through a parallel registry, the UK chose an auction reserve price set at 22€/tCO₂ and a cost-containment mechanism, instead of an MSR.

The UK auction reserve price currently set at £22²², below which bids will not be accepted, is a temporary tool to ensure a minimum level of ambition in the transition from EU ETS to UK ETS²³. It aims to be in place until a MSR becomes operational. The UK Cost-Containment Mechanism (CCM) requires the UK allowance average price in the previous two years to be doubled, for 3 months. This a substantial difference to the EU ETS Directive Art 29 that is only triggered when the EUA price is three times higher in comparison with the average of the 2 previous years, for 6 consecutive months. Prices have been on average 8% higher on the UK ETS than the EU ETS since May 2021, and the UK ETS cost containment mechanism was triggered in December and at the start of January 2022²⁴.

²¹ UK in a Changing Europe (2021): UK and EU Greenhouse Gas Emissions Trading Schemes. 14 June. Available at: <https://ukandeu.ac.uk/explainers/uk-eu-emissions-trading-schemes/#:~:text=What%20is%20the%20UK's%20Emissions,the%20UK%20and%20the%20EEA>. (Accessed on 1 February 2022)

²² UK Department for Business, Energy & Industrial Strategy (2021). UK Emissions Trading Scheme markets. Policy paper. 22 October. Available at: <https://www.gov.uk/government/publications/uk-emissions-trading-scheme-markets/uk-emissions-trading-scheme-markets> (Accessed on 1 February 2021)

²³ International Carbon Action Partnership (2021): ETS Detailed Information. United Kingdom. 17 November. Available at: [https://icapcarbonaction.com/en/?option=com_etsmap&task=export&format=pdf&layout=list&systems\[\]=99#:~:text=To%20ensure%20a%20minimum%20level,USD%2028.21\)%%20is%20in%20place](https://icapcarbonaction.com/en/?option=com_etsmap&task=export&format=pdf&layout=list&systems[]=99#:~:text=To%20ensure%20a%20minimum%20level,USD%2028.21)%%20is%20in%20place). (Accessed on 1 February 2021).

²⁴ Department for Business, Energy & Industrial Strategy (2022). UK ETS Authority Statement: Cost Containment Mechanism decision – January 2022. 18 January. Decision. Available at: <https://www.gov.uk/government/publications/uk-emissions-trading-scheme-ets-authority-cost-containment-mechanism-decisions/uk-ets-authority-statement-cost-containment-mechanism-decision-january-2022> (Accessed on 18 January 2022).

3.2. International developments

International link for the EU ETS

The UK ETS is an example of a desire of linking the EU ETS with other ETS worldwide. Indeed, UK Industry has showed concerns of a competitive disadvantage to the EU and has called for linking with the EU ETS²⁵. Although post-Brexit trade deal agrees to give serious consideration to linking carbon markets, there is no sign of negotiations to date.

The rule book on Article 6 of the Paris Agreement was agreed at the 26COP that took place on Glasgow on from 31st October to 12 November 2021. By leading by example, the EU has practically succeeded in achieving a compromise on the Art 6 and we now have instruments with strong environmental credentials. While announcements such as the Carbon Border Mechanism (CBAM) may have contributed to generate credibility (or pressure) to compromise to the climate goal, international ETS linking, as market instrument shall be further sought by international climate negotiators and policy makers.

4. Conclusions

The revision of the EU ETS Directive is the cornerstone of the Fit for 55 Package. Not only will it impact the functioning of the EU ETS in the years to follow, but also other EU legislative files relying on the EU ETS. This is for instance the case of the EC proposal for a CBAM (impacting current ETS provisions on free allocation and Innovation Fund), but also other legislative files under the Fit for 55 Package such as the Renewable Energy Directive (RED), the EU Fuels Maritime (regarding low carbon fuels for maritime activities), or EU Aviation fuels (regarding sustainable low carbon fuels for the aviation sector). For some files of the Fit for 55 Package, i.e: the Social Climate Fund, the success or failure of their final adoption will depend on the final shape and discussions happening during the ETS negotiation process.

The EU ETS, perceived as the main instrument to ensure the decarbonisation of the EU by 2050, as established by the European Climate Law, will determine the success of the whole climate ambition. This success is contingent on the negotiations between the Parliament and Council where discussion of the EU ETS legislative file will require further compromises and debate.

We can anticipate that the provisions on free allocation, social considerations, and funding to support the different decarbonisation instruments, will become the “hot potatoes” of the upcoming negotiation process. Under the current context of high energy prices, these matters will be affected by the development of the carbon price and rising speculation concerns.

²⁵Letter to Hon Boris Johnson, co-signed by 42 associations, on the Importance of Linking The UK ETS with The EU ETS Ahead of COP26. 14 April 2021. Available at: [https://www.ieta.org/resources/EU/2021%20UK-EU%20Linkage%20Joint%20Letter/UK-EU%20ETS%20Linkage%20Joint%20Letter%20\(UK\).pdf](https://www.ieta.org/resources/EU/2021%20UK-EU%20Linkage%20Joint%20Letter/UK-EU%20ETS%20Linkage%20Joint%20Letter%20(UK).pdf) (Accessed on 1 February 2021).

The ERCST will follow the upcoming developments closely, aiming to become a supportive and useful advisory body to both policy makers and the stakeholder community.

5. Overview table.

Core elements	ENVI draft report	Amendment	Commission proposal
Free allocation	- Option of transitional free allocation for modernisation of energy sector needs to be removed. - Introduction of a bonus-malus system & conditionality on climate neutrality plans (sectoral roadmaps) instead of conditionality on energy audits. - Temporary CBAM reserve with rolling review mechanism.	12 13, 51 15, 53, 54 55	- Max update rate of benchmarks to 2.5% as of 2026, up from current 1.6%. - Conditionality on implementation of measures in energy audits - Free allocation for CBAM sectors phased out by 2035.
Market Stability Reserve (MSR)	- To avoid CSCF, variable back-up of share of MSR allowances that would otherwise be invalidated.	30 58	- 24% intake rate maintained until 2030. - Buffer intake rate. - Allowances in MSR above 400 million will be cancelled. - TNAC calculations will include aviation.
Modernisation Fund (MF)	- Transfer 50% of the proposed MF top-up to projects under the Innovation Fund. - Member States may use transitional free allowances (Art 10c), not being allocated to operators by 31 December 2023, to support investments within the framework of the MF (10d). - Should not support nuclear.	46, 59 66 67	- Additional 2.5% of the cap is auctioned to increase MF - MF cannot finance investments in any type of FF
Innovation Fund (IF)	- Should not support nuclear - Should support agriculture, aviation and transport also. - At least 10% for railway systems and local public transport.	17 62 63	- 200 mln allowances added 150 from ETS 2. - Scope includes project support via Carbon Contract for Differences (CCfDs).

ETS extension maritime	- If global measure at IMO level is adopted and at least comparable to EU measures, scope of ETS should be reduced, if not, scope should be extended to 100%. - Move forward date of full application to 2025. - Include methane emissions, not only CO₂. - Establish an Ocean Fund.	8 6 5 10, 41	- All emissions from intra-EU, 50% from extra-EU and at berth in EU port. - As of 2026, shipping companies must surrender 100% of their emissions.
New ETS for road transport and buildings	- Should cover all fuels to ensure level playing field. - Applicable as of 2025 instead of 2026, with opt-out clause until 2027 for private road transport and residential building heating.	19	- Cap will be set from 2026, alongside LRF in line with 43% emission reductions by 2030. - Includes price-based cost-containment mechanism. - Separate MSR for both sectors operational as of 2027.
Municipal waste incineration	- By 31 December 2025, the European Commission (EC) to report to European Parliament (EP) and Council to evaluate the inclusion of municipal waste incineration installations in the EU ETS. - If positive, inclusion as from 1 January 2028.	44	
CSCF	Further strengthening its avoidance. - +57 million allowances bringing maritime into EU ETS from 2026 to 2025. - +12 million allowances phasing out faster from aviation sector free allocation (from 2027 to 2026). - Using allowances otherwise invalidated from the MSR.	6 30 34-36 37 39 56-57	
CCUS and negative emissions	- + Additional free allowances when CO₂ permanently removed through Bioenergy with carbon capture and storage (BECCS), Direct Air Capture (DAC) and permanently chemically bound.	2-3 62 71	- Exemption for CCU which is permanently chemically bound in a product.

	- Reduced surrendering obligations for chemically bound, LCA based. - By 2030, CCU emission accounting system should be reviewed aiming to move the counting of emissions to the point of release into the atmosphere. - Delegated act to decide when a product is permanently chemically bound.		- Implementing act to decide when a product is permanently chemically bound.
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