ERCST

Roundtable on Climate Change and Sustainable Transition

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POLICY BRIEF

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A reaction to the ENVI Committee Report

Summary

The recent developments at the European Parliament, as manifested by the ENVI Committee vote on 17 May, have showed that an agreed position on different elements of the EU ETS within the EU ETS community is far from being achieved. While some of the amendments may be consider effective to achieve the previously set decarbonisation goals, others are considered unrealistic and potentially damaging the integrity of the policy tool. This policy brief reflects the most recent developments in the political discussion and the sentiments of the EU ETS community.

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1. An on-going negotiation process.

On 17 May 2022 the Environment, Public Health, and Food Safety (ENVI) Committee of the European Parliament adopted its final report on the European Commission proposal to revise the EU ETS Directive[1]. The European Parliament will have to vote in plenary before the final adoption of the Report. If the Report is adopted in plenary, it will become the Parliament's starting position for the negotiations with the Council and Commission in September.

As voted on 17 May, the Report as a whole was supported by the main political groups with a 70% majority, while 20% did not support the text. PPE, Renew, S&D, Left and Verts/ALE[2] have made it possible for the ENVI position to move forward, while ECR and ID voted against it.

The majority translates in different ways for different amendments. Amendments related to ambition, cross sectoral correction factor (CSCF) or the reduction path of free allocation are just some of the ones worth highlighting in this context. All of them will be examined in detail during the European Parliament plenary vote of 6-9 June and may risk the final support from the Parliament.

Overall reaction

An examination of the agreed ENVI Report would seem to indicate a relatively strong shift towards environmental focus, with economic and competitive impacts taking second place. This is illustrated from what is being put forward on free allocation and the level of ambition.

While the set of proposals that the EU Parliament will take into the plenary vote is unlikely to make it as is, the goal posts have been shifted. Moreover, in the name of a compromise it is possible to end up with a Parliament position that may look good today but with significant risk for delivery.

Some of the provisions, such as the barring of financial institutions for the carbon market, may make the ETS price discovery, the real function of the EU ETS, a very poor shadow of what it should be.

2. Factual: what are the main changes?

One of the most striking and unanticipated changes of the adopted ENVI Report in comparison with the draft presented by ENVI on 24 January 2022[3] is the increase in ambition. In the final report, ENVI is calling for a 67% reduction of GHG emissions by 2030 (in comparison with 2005), contrary to the 61% GHG reduction target originally proposed by the European Commission (EC).

This increased ambition will mean a one-off reduction of the cap by 200 million tonnes of CO2 in 2024, instead of 117 million (as proposed originally by the EC). In addition, the tool determining the reduction path of the cap, the Linear Reduction Factor (LRF) would decrease by 0.1 percentage points annually, starting at 4.2%. The reduction of the Market Stability Reserve (MSR) thresholds, from 700 and 921 million allowances (instead of 833 and 1096 respectively, as proposed by the EC) will also add more stringency to the carbon market.

[1] Proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC establishing a system for GHGs 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 (COM (2021)0551 - C9-0318/2021 - 2021/0211(COD))

[2] PPE (European People's Party), S&D (Progressive Alliance of Socialists and Democrats), Renew (Renew Europe Group), Left Verts/ALE (Greens/European Free Alliance), ID (Identity and Democracy Group), ERC (Conservatives and Reformists Group).

[3] ENVI Draft Report on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC establishing a system for GHGs 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. 24 January. Available at: https://www.europarl.europa.eu/doceo/document/ENVI-PR-703068_EN.html (Accessed on 24 January 2022).

With respect to free allocation, ENVI is proposing to increase the minimum annual reduction rate of the benchmark from 0.2% to 0.4% starting in 2026. ENVI is also proposing to further develop the so-called bonus malus system, in which sub-installations outside of the 10% best performers will reduce free allocation even further if they do not implement decarbonisation plans and energy measures in time. However, the 10% best performers in a product benchmark will be rewarded with additional free allocation and avoidance of the CSCF in case this is triggered. As for CBAM sectors, the full phase out of free allocation would take place in 2030, 5 years before what was originally proposed by the EC.

While the extension of carbon pricing to road building and transport (ETS 2) has been one of the most controversial issues during the internal discussions in ENVI (and the Council), the political groups agreed to exclude private road transport and buildings (at least until 2029 and pending an EC impact assessment).

The ENVI Committee is also proposing to reinforce the monitoring and transparency of the carbon market. Not only will the EC be required to present a legislative proposal following the European Stability Market Authority (ESMA) report, but ESMA would also be required to publish regular reports. To address excessive price fluctuations, the Article 29a of the EU ETS Directive would allow the EC to bring allowances from the MSR back into the market. Furthermore, ENVI aims to limit speculation and the influence of financial entities on the carbon market. Apart from the central and national administration accounts, ENVI proposes that only regulated entities with EU ETS compliance obligations may hold allowances.

The stronger role ENVI is giving to the European Scientific Advisory Board on Climate Change should be highlighted. Supported by the secretariat of the European Environmental Agency (EEA) and composed of 15 academic experts across the EU, the recently created Advisory Board, following the mandate given to it by the European Climate Law, will influence key topics. Among them, there are free allocation, benchmarks, the minimal requirements for decarbonisation plans which ETS installations have to provide so as not to lose their free quotas, MSR, ETS ambition in line with international climate developments, and even investment decisions under the EU ETS (for instance regarding the Modernisation Fund).

3. The EU ETS discussion

Following the recent political developments, we have identified several areas of concerns as voiced by representatives of the EU ETS community.

1. Ambition

The European Climate Law requires Europe to become a net zero society by 2050. An intermediary target of 55% GHG emission reduction by 2030 (vs 2005 levels) is set on the way to achieving this goal. As their contribution to this goal, the EU ETS sectors will have to reduce their GHG emissions by 61% by 2030. The willingness to increase this ambition further, through a more stringent cap, is aligned with the general assumption that a decreased supply of allowances and an increase of the price will trigger decarbonisation. The issue at hand is the speed with which this is achieved, with, in our view, the risk of either not achieving what is being legislated or achieving it at a very significant social and economic cost. Higher prices do not and cannot automatically translate in speed of asset turnover.

2. Road, buildings and transport.

Since its announcement, the EC proposal to extend carbon pricing to suppliers of fuel used in road transport and in buildings has raised some concerns in the political community. The proposal for a Social Climate Fund to alleviate the potential negative impact on poor households has not been enough to alleviate these concerns and compromises have been needed to achieve a consensus. If ENVI's proposal moves forward, the only certainty is that the fuel used for combustion in non-private road transport and non-private heating, or cooling, of buildings will be included in carbon pricing. However, in many cases it may be difficult for fuel supplier to distinguish to whom they are selling the fuel (to a private or to a commercial entity) and it may, therefore, be difficult to implement the system.

3. Competitiveness and carbon leakage.

In the EU, free allocation is the main tool to compensate for direct carbon costs which arise due to climate policies in the EU being stricter than in many other jurisdictions. Whether a CBAM aims to progressively replace free allocation as the main alternative to address carbon leakage, some questions remain regarding its effectiveness in ensuring decarbonisation without harming EU competitiveness.

The ENVI amendments are a clear call to accelerate the phase out of free allocation by rewarding the 10% best performers at the expense of the other 90%. Similarly, the CBAM amendments aim to phase out free allocation faster. The views are split on this approach, with a rapid implementation of CBAM supported by some stakeholders, while others would prefer a more gradual introduction.

However, many stakeholders question whether ENVI's amendments on CBAM will hold up in the full Parliament, given that the margins for their adoption were already tight in ENVI. The possibility of the amendments related to CBAM, and free allocation being revoked in the plenary is still present.

4. Market.

By providing liquidity to the market and reducing transaction cost, financial entities are drivers of financial flows and market efficiency. In many cases, financial entities act on behalf of compliance actors who rely on them to undertake market operations. Besides price discovery another important function of the EU ETS is risk hedging, but with no one on the other side of a transaction, that risk will prove increasing unrealistic.

While limiting the participation of financial operators and avoiding an excessive degree of speculation could be perceived as desirable, the real-life consequences need examination and input by those that understand markets, if the EU ETS is meant to be a market. Further reflection requited - this almost sounds as a bargaining chip.

What is more concerning, is also the fact that no serious intervention is perceived as necessary in Art 29a regarding market volatility. What is proposed is tinkering at the very edges, but this will not make a difference if there are real problems.

5. Advisory Board on Climate Change.

The role and function of an intellectual Board, being scientific, needs to be thoroughly examined and considered. Such Board, while advisory in nature, could end up providing "de facto" functions that belong to the political discussion makeup domain.

6. Other concerns.

The deployment of hydrogen and carbon capture techniques, better accounting of carbon removals, a holistic approach to the Fit for 55 Package where the EU ETS does not stand alone, keeping indirect cost compensation, the consideration of exogenous elements impacting the carbon market (i.e. energy market, war, inflation, macroeconomic context), differentiating between short and long term goals, the incremental funding support under a stricter climate policy (i.e. Innovation and Modernisation Fund), and the lack of alternative energy sources (i.e. nuclear and gas) during the transition; are some of the other concerns raised requiring further attention under the upcoming negotiation process.