ERCST

Roundtable on Climate Change and Sustainable Transition

POLICY BRIEF

EU ETS Review
2 months after the start of trilogues

Summary

The EU ETS is considered the cornerstone of EU Climate Policy. Such is its potential to combat climate change. But the high expectations could become drawbacks, as the community increasingly seeks a tool to cure energy woes.

In this policy brief, we reflect the feeling of the stakeholder community regarding the most recent discussions. While external events are attracting considerable attention in the debate (e.g., energy crisis), the comprehensive revision of the EU ETS should not be overlooked. Moreover, other measures under discussion (i.e., ETS extension to new sectors, free allocation, carbon market transparency, etc.) are worthy of keen attention during the on-going revision.

Authors
Andrei Marcu, Juan Fernando López Hernández

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1. Introduction

In June, both the EU Council and the European Parliament each adopted their own positions on the revision of the EU ETS Directive. With the first step of the process achieved, the interinstitutional negotiations (European Parliament, Council and Commission) officially kicked off on 11 July. However, the EU ETS legislative process is becoming a dynamic phenomenon with both EU institutions continuing to shape their respective views on the final EU ETS legislation text.

For the analysts following the process, the dynamic approach is more exciting. But tracking policy priorities under the on-going trilogues becomes more complex. In June, the extension to road building and transport, the phase out of free allocation, and the role of speculation in the carbon market looked to be key priorities where consensus had to be achieved, while now new elements of discussion are on the table.

Furthermore, the use of the EU ETS as an instrument to address the current energy crisis is another hot topic and looks to remain so during the upcoming months. Any common positions still pending must be resolved before the end of the year, to achieve the timing targeted by EU authorities.

2. A carbon market overtaken by the wider energy context.

- **The impact of RePower EU on the carbon discussion**

On 18 May the European Commission proposed the "REPowerEU Plan" as an attempt to make the EU more energy resilient and independent from external shocks of energy supply. RePower EU is a comprehensive strategy aiming to save energy, diversify energy sources and accelerate clean energy transition. This has become the principal response of the EU to the on-going energy crisis exacerbated by gas shortages created by the current conflict in Ukraine.

- **The EU ETS is not to blame**

The EU ETS is not immune to the energy discussion and given that EU policy makers have been quick to decouple the energy and carbon prices ["von der Leyen said ETS costs were contributing only around 6% of the electricity price, versus 94% caused by other factors[1]"], the EU ETS is seen as contributing to address the problem. Estimates provided by the Spanish Central Bank[2] attribute 20% of 2021 price developments to ETS prices, while, according to Ember[3], the price increase of emitting a tonne of carbon (in the EU-ETS) equated to 10% of the increase in gas generation costs in 2021.

- **The EU ETS cash attraction**

The European Commission has proposed that revenues generated by the auction of EUR 20 billion worth of EU ETS allowances from the Market Stability Reserve (MSR) to be allocated over four years towards financing the new REPowerEU-related measures. The proposal implies amendments to both the EU ETS Directive and MSR Decision, beyond those already proposed under Fit for 55.

- **Preserving the integrity of the EU ETS**

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[1] F. Simon (2022): "EU's von der Leyen rebuffs Polish call to suspend carbon market". EurActive. 31 August. Available at: https://www.euractiv.com/section/emissions-trading-scheme/news/eus-von-der-leyen-rebuffs-polish-call-to-suspend-carbon-market/ (Accessed on 20 September 2022).

[2] Pacce M., Sánchez I., Suárez-Varela, M. (2021): "Recent developments in Spanish retail electricity prices: The role played by the cost of CO^2 emission allowances and higher gas prices". Bank of Spain. Documentos Ocasionales. N. º 2120. August.

[3] Moore C., (2021): "European Electricity Review 2022". Ember. 1 February.

The potential impact of RePower EU on the EU ETS has triggered substantial discussion within the stakeholder community. Two main positions are established: 1) Those in favour, as a short-term measure needed to trigger the funding required for energy transformation. 2) Those against the measure and heavily concerned not only about the potential disruption in the carbon market, but also about the scope and precedent it could set for similar interventions in the EU ETS in the long term.

- **Changing mindsets**

The measure was widely criticised at its origin, but supporters have grown overtime. At the time of writing this article, the ENVI Committee of the European Parliament is calling to auction EUR 20 billion worth of allowance sourced from frontloaded member state auctions spread over three years. Member States such as the Netherlands and Denmark have proposed raising EUR 10 billionn in 2023-26.

RePower EU shows clearly that no proposal can be taken as definitive at this stage. As nothing has been decided, therefore everything could change between now and the end of the negotiation process.

3. The role of speculation

- **Proposal to limit the role of non-compliant entities.**

The impact of RePower EU may be overshadowing the discussion on other important topics. A clear example is the debate on the role of non-compliance[4] entities in the EU Carbon Market. The debate on the issue of speculation in the EU carbon market started last year, when some voices raised the concern that financial entities participating in the carbon market were using their CO_2 certificates to obtain substantial profits, increasing the cost for ETS compliant entities. Compliant entities hold the obligation to buy allowances to avoid paying heavy fines if they emit CO_2 over the pre-defined threshold, and some stakeholders see this as an unhelpful situation.

In the current energy context, these complaints have helped to create doubts about the role of liquidity provider. Important publications are the EC Communication on “Tackling rising energy prices: a toolbox for action and support”[5], the ESMA Preliminary[6] and Final[7] reports on emission allowances and derivates thereof. While these studies have triggered the need to further enhance market transparency and monitoring of the carbon market, no clear evidence of market abuse has been identified so far.

- **Recent developments**

While neither the European Commission nor the Council have featured elements to restrict the access of non-compliance actors in the carbon market, the issue of speculation has been seriously considered by the European Parliament, who in its adopted position of 22 June indicated that besides the central and national administration accounts, “only regulated entities [or mandated on their behalf] with past, current, or predictable future EU ETS compliance obligations may hold allowances”[8].

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[4] “Compliance entities are companies and aircraft operators obliged to participate in the EU ETS. Non-compliance entities, such as credit institutions, investment firms, funds and commodity trading firms (which have no compliance requirements), can also participate.” Ampudia, M. et al. (2022): The role of speculation during the recent increase in EU emissions allowance prices (ECB). ECB Economic Bulletin, Issue 3/2022. Available at: https://www.ecb.europa.eu/pub/economic-bulletin/focus/2022/html/ecb.ebbox202203_06~ca1e9ea13e.en.html (Accessed on 21 September 2022).

[5] COM (2021) 660 final.

[6] ESMA (2021): Preliminary report on emission allowances and derivates thereof”. 15 November

[7] ESMA (2022): Final report on emission allowances and derivates thereof”. 28 March.

[8] European Parliament (2022): “Revision of the EU Emissions Trading System”. Adopted. Amendment 570. 22 June.

The European Commission is also moving forward, and DG CLIMA has recently started a study to assess the market operation and the relevance compliance entities give to financial institutions[9].

- **Do we want financial actors?**

Multiple stakeholders have opposed the attempts to limit the access of financial entities to the carbon market. As an example, and most recently, the position paper released on 15 September entitled "Safeguarding the proper functioning of the EU Emissions Trading System (ETS)" [10].

This, and other publications, defend the positive role of financial institutions as drivers of risk management related to price fluctuations, client facilitators, market liquidity, price visibility, reduction of administrative participation cost (particularly for smaller entities) and hedging against future price fluctuations. While a higher degree of control and transparency is always required to increase confidence in the carbon market, restricting access to financial entities will impact market efficiency.

4. Keep in mind

It is obvious that RePowerEU, and the role of speculation in the carbon market are the hottest topics under discussion. However, other topics are not currently in the public eye and deserve attention:

- CCSU[11] and the role of carbon removals: how will the EU ETS Directive consider the CO_2 which is removed and released/not released? At what point in the value chain? What interlinkages in the case of CCU and CCS? Should they be discussed altogether?

- The extension of carbon pricing to municipal waste incineration: When will municipal waste be included in the EU ETS? What impact on landfills?

- Energy audits for installations receiving free allocation: How to link carbon abatement and energy efficiency legislation?

Among all these issues still to be discussed and for which a common position is missing, we should not forget the potential extension of carbon pricing to fuel suppliers in the road transport and building sectors. This is a politically sensitive measure and the social implications of the proposal have triggered one of the main flashpoints in the European Parliament. Indeed, the European Parliament position on the revision of the EU ETS Directive had to be voted twice in plenary.

In the current negotiation process, achieving this extension is vital. An ETS which partially covers CO_2 emissions of buildings, and the transport sector may seriously undermine the credibility of the tool.

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[9] This study is led by European Economics and a survey to compliant entities was distributed in September 2022.
[10] AFME, EBF, FIA, EFET, Eurelectric, Europex, IETA, ISDA (2022): "Safeguarding the proper functioning of the EU Emissions Trading System (ETS)". 15 September 2022. Available at: https://www.europex.org/press-releases/joint-association-call-to-safeguard-the-proper-functioning-of-the-eu-emissions-trading-system-ets/ (Accessed on 21 September 2022)
[11] Carbon Capture, Utilisation and Storage of CO2.