

POLICY BRIEF

EU ETS Review Political agreement after trilogues

Summary

The EU ETS is considered to be the cornerstone of the EU Climate Policy. The EU institutions achieved a provisional deal on December 18, concluding the interinstitutional negotiations that began on July 11.

In this policy brief, we reflect on the main points that have been disclosed at this time with the clear understanding that this may require an update when the official text emerges. The formal adoption by both the European Parliament and Council is expected to take place during the first quarter of 2023, and the EU ETS Directive to be implemented afterwards. The revised EU ETS should apply as of 2024.

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To reference:

Marcu, A., López Hernández J.F., De Graeve, B. (2023): “EU ETS Review. Political agreement after trilogues”. ERCST. January 2023.

1. Introduction

On 14 July 2022 the European Commission presented its proposal to revise the current European Union Emissions Trading System (EU ETS)¹. The proposal modifies and aligns the existing EU ETS target of 43% GHG emission reduction by 2030 (vs 2005 levels) with the Fit for 55 Package goal, aiming at least 55% GHG emission reduction for the whole EU economy by 2030 (vs 1990 levels).

Following the usual political procedure, both the EU Council and the European Parliament adopted their initial reactions to the proposal of the European Commission in June. With the first step of the political process achieved, the inter-institutional negotiations between the European Parliament, Council and Commission officially kicked off on 11th July 2022.

Although the original objective was to achieve a final legislative shape before the international COP27 in November (which would show the EU climate commitment to the rest of the world), both the exhaustive list of topics covered and the intensive negotiations, delayed the process². In the end, the European Parliament and Council achieved a provisional agreement on 18 December 2022.

The political compromise now has to be formally adopted by both the Council and European Parliament. After this formal adoption, which is expected to happen in February-March, the EU ETS revised Directive will be set into law and enter into force. Secondary legislation (implementing and delegated acts complementing the EU ETS Directive) will follow.

2. What has been agreed³?

- Ambition

The new EU ETS Directive will accelerate the pace at which EU ETS covered sectors are required to decarbonise. The EU ETS Directive will require now a 62% GHG emission reduction (compared to 2005 levels). This target will be achieved in two ways: a two-off stage reduction in the cap: 90 million EUAs in 2024 and 27 million EUAs in 2026; and a decrease of the Linear Reduction Factor (LRF) of 4.3% in 2024, and of 4,4% in 2028 until the end of Phase IV.

- Market Stability Reserve

The debate about the MSR⁴ will continue in the future, pending a revision in 2026. As per the Commission proposed, a 24% intake rate will extract allowances from the carbon market if the Total Number of Allowances in Circulation (TNAC) is above an upper threshold of 1096 million EUAs. If the

¹ Proposal for a Directive of the European Parliament and of the Council 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. COM/2021/551 final. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0551>

² Not surprisingly, the fact that no agreement could be reached by the policy makers was a real threat during some stages of the negotiation.

³ The provisions below present the elements of the EU ETS political agreement as disclosed by media and relevant policy makers and should be taken as indicative. The final EU ETS provisions may be slightly modified pending the formal adoption of the EU ETS legislative text.

⁴ Perino, G., Willner, M., Quemin, S., & Pahle, M. (2022). The European Union Emissions Trading System Market Stability Reserve: does it stabilize or destabilize the market? *Review of Environmental Economics and Policy*, 16(2), 338-345.

TNAC is between the upper threshold (1096 million EUAs) and the lower threshold (833 million EUAs), a buffer difference of TNAC – 833 million EUAs will be taken out from the carbon market.

Allowances held in the reserve over 400 million EUAs will be invalidated as from 2023.

- Carbon leakage

The parallel discussion on the Carbon Border Adjustment Mechanism (CBAM) has impacted the revision of the EU ETS. Here we need to differentiate between goods that are covered by CBAM and non-CBAM covered sectors. Both types of goods are recognised under carbon leakage risk.

For CBAM sectors (steel, iron, cement, fertilizers, aluminum, electricity, and hydrogen) the phase out of free allocation will be faster, starting in 2026. The CBAM factor will replace free allocation in parallel, reaching a full phase out of free allowances by 2034. Policymakers have introduced a review clause in 2025. By this time, the European Commission is required to come up with a WTO-compatible solution for exports, if needed, and to guarantee that the carbon leakage protection of CBAM sectors will not be undermined under a stricter climate policy.

For non-CBAM sectors at risk of carbon leakage, the European Commission will determine the level of phase out of free allocations during the benchmark exercise. These sectors will reduce their free allocation quotas by an annual percentage between 0.3% and 2.5%, starting in 2026.

The conditionality on free allocation is a new requirement to incentivise energy efficiency deployment in EU ETS installations. It is based on the provisions on energy audits as taken from the Energy Efficiency Directive for which installations receiving free allocation will have the obligation to implement energy audits or energy management recommendations, to avoid losing up to 20% of their free allocation. On top of that, the 20% worst performers in a benchmark curve will be required to implement decarbonisation plans.

- Maritime

The emissions emitted by transport maritime will be integrated in the current EU ETS as from 2025. It will include CO₂ emissions of most large vessels. Coverage will be progressive, starting in 2025 with 40% of the emissions emitted in 2024 and aiming to achieve full coverage of intra-EU voyages by 2027⁵.

From 2026, non-CO₂ emissions such as nitrous oxide (N₂O), soot and methane could also be included in the system. From 2027 the scope may be extended to ships over 400 gross tonnages (GT), pending a revision in 2026. Offshore vessels over 5000 GT will be included in the EU ETS from 2027.

The EU policymakers have also recognised a list of derogations and measures to avoid carbon leakage. Maritime transport is a sector that will not receive free allocation nor be protected by CBAM. This means that the EU ETS Directive will require the publication of a list of neighbouring transshipment ports to avoid evasive behaviour of carbon requirement. The agreement also recognises derogations for ice-class ships, small islands, outermost EU regions and public service journeys between Greece and Cyprus.

⁵ 50% of extra-European routes, meaning voyages from an EU port to a port outside EU jurisdiction and vice versa.

- EU ETS 2

The extension of carbon pricing to fuel suppliers in road transport and building sectors has been the most controversial point of discussion during the whole negotiation process. In the end, the so-called ETS2 will apply starting from 2027, with several safeguards.

The first safeguard is the one-off emergency brake. If energy (gas) prices are as high as they were in February – March 2022, the policymakers will postpone the launch of the EU ETS2 to 2028. The second safeguard is the price-cap stabilisation mechanism, for which the MSR will automatically bring allowances into the market in case the EU ETS price goes above 45 EUR/tons of CO₂. In this case, the MSR will release 20 million additional units in the market.

In addition, and to avoid double burden, where a national system is already in place, Member States will have the possibility to exempt fuel suppliers from surrendering EU ETS allowances until December 2030.

The final agreement does not change the original proposal of the European Commission regarding the decarbonisation path. An annual LRF of 5.15% will retroactively apply from 2024 over the annual cap, to become 5.43% from 2028.

- Market and transparency

The question of how to improve transparency of compliant and non-compliant actors in the carbon market has been one of the most discussed topics during the second half of 2022⁶, ahead of the publications of the European Stability Market Authority (ESMA) Final reports on emission allowances and derivatives thereof⁷. We can see the consequences of this discussion in the EU ETS political agreement.

Firstly, EU policymakers agreed not to limit access to financial entities. This was a demand of some Member States and the European Parliament during the negotiation process. Instead, the EU ETS text will ask for more ESMA oversight and additional disclosure requirements to financial entities⁸.

Secondly, policymakers have decided to facilitate triggering article 29a of the EU ETS Directive to address excessive carbon price movements. The MSR will release 75 million EUAs into the carbon market if the EUA price for 6 months is more than 2.4 times the average price, over the precedent 2 years.

- Aviation

The amendments are oriented towards the phase out of free allocation for aviation, the progressive integration under the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), and the extension to non-CO₂ emissions.

Starting in 2024, flights will have to progressively reduce free allocation aiming to full auctioning in 2026. In addition, by July of the same year, the European Commission will assess the effectiveness of CORSIA

⁶ In March 2022 the ERCST organised some events focus on the issue of transparency of the EU carbon market and Article 29a of the EU ETS Directive to address excessive price speculation. The results of the discussion were presented on ERCST EU ETS Directive Review: A focus on the Article 29a, available at: <https://ercst.org/eu-ets-directive-review-a-focus-on-the-article-29a-07-03-2022/> (Accessed on 12 January 2022).

⁷ ESMA (2022): Final report on emission allowances and derivatives thereof". 28 March.

⁸ The details and extension of the role of ESMA in the carbon market have not been made public yet.

and make a proposal to extend the carbon pricing to all departing flights from the European Economic Area. As of 2027, flights to third countries not applying CORSIA will fall under the EU ETS.

In 2027, the European Commission will evaluate the potential inclusion of non-CO₂ emissions from aviation. In the case of a positive assessment, these emissions will be included in the EU ETS one year later. In addition, up to 20 million allowances will be reserved for operators using Sustainable Aviation Fuels (SAFs). The conditions for the use of these allowances will be in the final text.

- Funding and revenues

The Innovation Fund and Modernisation Fund will remain the main EU ETS tools supporting the decarbonisation of EU industry. A higher ambition will require a higher level of support to deploy low carbon technologies and regional transformation, and both the Innovation Fund and Modernisation Fund will be increased accordingly.

With a total envelope of at least 57 million EUAs, the Innovation Fund will pay particular attention to CBAM sectors. The European Parliament was asking for the creation of a specific Ocean Fund that the EU ETS political agreement has finally deleted. Instead, DG CLIMA will propose specific dedicated calls to support the decarbonisation of the maritime sector. The successful applications under the Innovation Fund calls will be geographically balanced.

The revised EU ETS Directive will increase the funding of the Modernisation Fund from 2% of the total number of EUAs to 2.5%. In addition, the list of Member States that can make use of this Fund will be extended to include Greece, Slovenia and Portugal. Natural gas projects will still benefit from the Modernisation Fund during a transitional period and under specific conditions.

- Extension to municipal waste.

In addition to maritime, road transport and buildings, the policymakers wish to extend carbon pricing to include municipal waste. The monitoring of the emissions generated by the waste sector will start in 2024, followed by an impact assessment in 2026, and a potential inclusion in 2028-2030.

- Carbon Removals

There is a willingness for a later integration of carbon removals under the EU ETS in the future. The expected text will not benefit carbon removals, but it will not raise surrendering obligations when the GHGs emissions are chemically bound, thus not emitted into the atmosphere.

The European Commission will study the inclusion of carbon removals under the EU ETS by 2026.

- RePower EU

The Commission proposed a RePower EU agreement during the EU ETS negotiation process to reduce EU dependence of Russian gas, ensure price affordability and EU security of supply. It will have an impact on the EU ETS, raising €20 billion from three ETS auction pots – a move that will backload ETS ambition by easing supply in the coming three years but will tighten volumes over 2026-30.

The agreement entails that 40% of the funding will come from front-loaded EUA auctions (earlier than scheduled). The remaining 60% will be raised through sales of EUAs currently earmarked for the Innovation Fund (from this 60%, 10% which will then be partly replenished with EUAs from the MSR).

3. A slight look into the future

The 2022-2023 revision of the EU ETS Directive is the most radical transformation of all EU ETS revisions since its creation in 2005. As the cornerstone of the EU climate policy, the EU ETS is now facing a substantial evolution in terms of coverage and ambition, not previously seen before. By leading by example, the EU shows its firm objective to have a policy instrument at the level of the climate challenge and international expectation.

Still, this EU ETS transformation is far from being finalised. The political agreement we present in this policy brief generates open questions about the successful implementation of the EU ETS until 2030, and consequently, its potential shape after 2030:

- Implementation of the CBAM and its impact on the carbon market.
- Implementation of a new and parallel carbon system for road transport, building and other process emissions.
- Extension of carbon pricing to municipal waste.
- The integration of carbon removals under the EU ETS.

These are only some examples of the different challenges. There are many loopholes still to be resolved, and a wrong evaluation of these challenges could undermine the credibility of the process and the confidence in the system in the years ahead.

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Annex I – Status of the revision of the EU ETS

(After political agreement - Last update 16 January 2023)

**The political agreement column includes all elements that have been disclosed by EU policy makers so far. This is a non-exhaustive list and provisional pending formal endorsement. Formal approval by the Council and Parliament is expected in early 2023.*

Topic	Parliament	Council	Political agreement
Ambition (Cap, LRF, Adjustment)	- 63% in 2030 (vs 2005), pursuing 1.5 objective. Reduced two-off caps emissions: ➤ 2024: 70 Mt EUAs ➤ 2026: 50 Mt EUAs. LRF: 4.4% in 2024, 4.5% in 2026, 4.6% from 2029.	- 61% in 2030 (vs 2005). Reduced one-off cap emissions: ➤ 2024: 117 Mt EUAs. LRF: from 2.2% to 4.2%.	- 62% in 2030 (vs 2005). Reduced two-off caps emissions: ➤ 2024: 90 Mt EUAs ➤ 2026: 27 Mt EUAs. LRF: 4.3% (2024-2027), 4.4% (2028-2030).
MSR	24% IR until 2030. Upper threshold: 921 M EUAs. Intermediate threshold: 700 M EUAs. Lower threshold: 400 M EUAs. Dynamic thresholds: to reduce in line with LRF from 2025.	24% IR until 2030. Upper threshold: 1096 M EUAs. Intermediate threshold: 833 M EUAs. Lower threshold: 400 M EUAs. Invalidation: 400 M EUAs.	24% IR until 2030. MSR Review in 2026. Upper threshold: 1096 M EUAs. Intermediate threshold: 833 M EUAs. Lower threshold: 400 M EUAs. Invalidation: 400 M EUAs.
Carbon Leakage	Max rate: From 1.6% to 2.5% as of 2026. Min rate: From 0.2% to 0.4% as of 2026.	Max rate: From 1.6% to 2.5% as of 2026. Min rate: 0.2% as of 2026.	Max rate: From 1.6% to 2.5% as of 2026. Min rate: 0.3% as of 2026.
	Excluding data of the three least emission-intensive installations that either started operating after 2017 or received free allocation based on another benchmark.	The annual reduction of hot metal will not be affected by the change of benchmark definitions and system boundaries.	No benchmark update for steel.
	Bonus-malus system on free allocation: ➤ (1) Installation to implement	Not featured elements on free allocation conditionality on energy audits.	Bonus-malus system on free allocation: If under 20% worst performing in a benchmark

	decarbonisation plan & (2) Energy audits or Energy Management recommendations (payback 8 years). ➤ If 1 <u>or</u> 2 are missing, free allocation deduction (from 25% up to 50%). If both are missing, it will double. + 10% free allocation for +10% best.		product: ➤ (1) Installation to implement decarbonisation plan & (2) Energy audits or Energy Management recommendations ➤ If 1 <u>or</u> 2 are missing, free allocation deduction (- 20%). All other installations only need to meet (2). Allowances will feed the Innovation Fund.
	No CSCF for best 10%.		No CSCF for best 10%.
	CBAM's free allowances phase out by 2032: -7% in 2027, -9% in 2028, -15% in 2029, -19% in 2030, -25% in 2031, 25% in 2032.	CBAM's free allowances phase out by 2035: -5 % each year (2026- 2028), - 7.5 % (2029 to 2030), - 10% (2031 to 2032), - 15 % (2033 to 2034) and - 20 % in 2035.	CBAM's free allowances phase out by 2034: -2.5 % in 2026, - 5% in 2027, -10% in 2028, -22.5% in 2029, 48.5% in 2030, - 61% in 2031, -73.5% in 2032, -86% in 2033, 100% in 2034. CBAM review clause in 2025 (including export analysis).
Maritime	Starting in 2024: ➤ Ships and/ over 5000 GT ➤ Full auctioning, with 100 % intra-European routes. Coverage: Intra-EU + 100% of extra-European routes. From 2027: ➤ Ships over 400 GT. ➤ 100 % of all routes covered.	Starting year (+1) after ETS Directive rev: ➤ Ships and/over 5000 GT ➤ Full auctioning, with 100 % intra-European routes. Coverage: Intra-EU + 50% of extra-European routes. From 2027 (if EC positive assessment): ➤ Ships over 400 GT. ➤ Additional GHG emissions.	Starting in 2025: ➤ in 2025: 40% of the emissions emitted in 2024 will be paid for. ➤ in 2026: 70% of 2025 emissions. ➤ in 2027: 100% of 2026 emissions. Coverage: Intra-EU + 50% of extra-European routes. From 2026: ➤ All non-CO₂ emissions (such as nitrous oxide (N₂O), soot and methane). In MRV from 2024. From 2027: ➤ All emissions for ships and/over 5000 GT (monitoring from 2025). ➤ Ships over 400 GT pending revision in

	Measures to avoid CL. Extension to methane and nitrous oxides (by 2025 if EC assessment). Derogation for ice-class ships and outermost regions.	Measures to avoid CL (i.e., list of neighbouring transshipment ports by 2023). Derogation for ice-class ships (-%5 EUAs surrendering requirement), islands, outermost regions, and public service journeys.	2026 (monitoring from 2025). 3.5% of auctioning allowances extra to MT, CY and EL. Measures to avoid CL (list of neighbouring transshipment ports within 300 nautical miles from EU ports). Derogation for ice-class ships, small islands, outermost regions, and public service journeys (between Greece and Cyprus).
ETS2	Starting in 2025: ➤ Commercial transport and building. ➤ Price cap of 50€. From 2029: ➤ Private from 2029 and only after 2026 IA. LRF 5.15% from 2024 & 5.43% from 2028.	Starting in 2027. Simplified MRV for regulated entities whose annual emissions are < 1000 tonnes of CO₂. MS exemption if national carbon tax. LRF 5.15% from 2024 & 5.43% from 2028.	Starting in 2027 (or 2028 if emergency brake). - One-off emergency brake: Not to launch ETS2 (1 year delayed) if energy prices are as high as February-March 2022. Price cap/stabilisation mechanism 45 EUR/t max, with automatic release from MSR. Member States can exempt fuel suppliers from surrendering allowances until December 2030, if subjected to national carbon tax. LRF 5.15% from 2024 & 5.43% from 2028.
Market & transparency	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.	Not featured elements to restrict the access of non-compliance actors.	Not to limit access to financial entities.
	Triggering: If the CO ₂ price for 6 months is more than 2 (before 3) as high as the average over the 2 previous years, policymakers can consider adding more	Triggering: If the CO ₂ price for 6 months is more than 2.5 (before 3) as high as the average over the 2 previous years, policymakers shall add more permits to the	Art 29a. Automatic release (75 million EUAs from MSR) if the EUA price for 6 months, is more than 2.4 times the average price, over the precedent 2 years.

	permits to the system, including 100 M EUAs from MSR. EC has to decide within 7 days if increase is due to market fundamentals, if not, take action (no automatic release from the MSR)	system: 75 EUAs from MSR. <u>Automatic</u> release from MSR. EC to publish average allowance prices within 1st three working days of each month.	<u>Automatic</u> release from MSR.
Aviation (adopted on 8 June)	Full auctioning by 2025. Extend the current scope: Flights from EEA to 3rd countries.	Full auctioning by 2027. Maintain the current scope: inter-EEA flights only. 20 M of free EUAs phased-out to compensate for SAFs costs.	Full auctioning by 2026: - -25% free allocation by 2024. - -50% free allocation by 2025. - -100% free allocation by 2026. Maintain the current scope: inter-EEA flights only (including UK + Switzerland). - But EC will assess the effectiveness of CORSIA by 1st July 2026 and come up with a proposal to extend the ETS to all EEA departing flights if one of the two following criteria is <u>not</u> met: 1. Level of participation in CORSIA represents at least 70% of international aviation emissions. 2. CORSIA improved to allow the achievement of the ICAO target zero emissions by 2050. - As of 2027, flights to third countries not applying CORSIA will fall under the ETS. 20 million allowances, between 1 January 2024 and 31 December 2030, for commercial aircraft operators that increase their use of SAFs, such as hydrogen from renewables, renewable fuels from non-biological origin and advanced biofuels. Extension to non-CO₂ aviation emissions: - MRV as of 2025.

		Geographical derogations.	- Evaluation in 2027. - EC Proposal to extend EU ETS scope in 2028. Geographical derogations: - Until 2030, for outermost regions (same MS). - Small islands, small airports and outermost regions will be able to cover the price differential between kerosene and eligible fuels with 100% of the SAF allowances. For all other airports, the price differential will be modulated according to the type of fuel: - 95% for renewable fuels of non-biological origin (RFNBOs) - 70% for advanced biofuels - and 50% for other eligible fuels.
Funding & Revenues	Innovation Fund: Total envelope: 450 M EUAs. ➤ Renamed “Climate Investment Fund”. ➤ Particular attention to CBAM sectors, including exports.	Innovation Fund: Total envelope: 412,5 M EUAs. Particular attention to CBAM sectors and decarbonising the maritime sector (with specific dedicated calls). Revenues from auctioning 5 million EUAs for aviation.	Innovation Fund: Total envelope: At least 575 M EUAs. Particular attention to CBAM sectors and decarbonising the maritime sector (with specific dedicated calls). ➤ Including, revenues from auctioning 5 million EUAs from aviation. ➤ Including, 20 M EUAs from shipping. Consideration of geographical balance during the calls.
	Modernisation Fund: ➤ 2.5% of the total EUAs ➤ Beneficiaries: MSs GDP < 65%	Modernisation Fund: ➤ 2.5% of the total EUAs ➤ Beneficiaries: MSs GDP < 75%. No support to fossil fuels but natural gas	Modernisation Fund: ➤ 2.5% of the total EUAs ➤ Beneficiaries: MSs GDP < 75%. New commers participating are Greece, Slovenia and Portugal.

		derogation.	No support to fossil fuels but natural gas derogation.
	Ocean Fund: ➤ 75% of maritime revenue (around 90 M EUA) to Ocean Fund to make ships and ports climate friendly.		No Ocean Fund but 20 million EUAs in Innovation Fund for shipping.
	20 EUR Billion from EU ETS auction revenues to RePowerEU: - 100% frontloading. - Over 3 years.	20 EUR Billion from EU ETS auction revenues to RePowerEU: - 75% from IF. - 25% frontloading.	20 EUR billion from EU ETS auction revenues to RePowerEU: - 50% from IF (10 EUR Billion). - 40% frontloading (8 EUR Billion): ○ From 2026-2030 to 2023-2025. - 10% MSR (2 EUR Billion). EUA sales will take place from 2023 until August 2026.
Municipal waste	Waste included in 2026 after impact assessment in 2024.	Waste not included before impact assessment by 2026.	Waste monitoring from 2024. Waste not included before impact assessment by 31 January 2026. Objective to bring waste under the EU ETS by 2028 with possible opt-out until 2030 as the latest.
CCU & CCS	No surrendering obligations when chemically bound. By 2025, EC methodology of accounting. Delegated instead of implementing act.	No surrendering obligations when chemically bound.	No surrendering obligations when GHGs chemically bound. The EC will study the inclusion of carbon removals under the EU ETS and not permanently bound in 2026.