ERCST

Roundtable on
Climate Change and
Sustainable Transition

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ERCST Reflection Note

EU ETS Review: Under the shadow of the energy crisis

Summary

The EU ETS has become a second priority. This is the attitude we currently observe in the political discussion. Whether this approach is justified or not in the current economic context, it may not be the best path to follow.

In the current unprecedented energy crisis, EU leaders are mainly concerned about fighting the upcoming winter by ensuring energy supplies.

In the meantime, we risk undermining the success of both, the EU and international climate policy (as the EU is a leader by example). The EU ETS has been the cornerstone of the EU climate policy since it was created in 2015.

In this reflection note, we urge policy makers and stakeholders to not abandon the focus on the long term, and to not undermine what has been already achieved. Credibility is key and the climate decisions of today will have an impact for years to come.

Authors

Andrei Marcu, Juan Fernando López Hernández, Bente De Graeve

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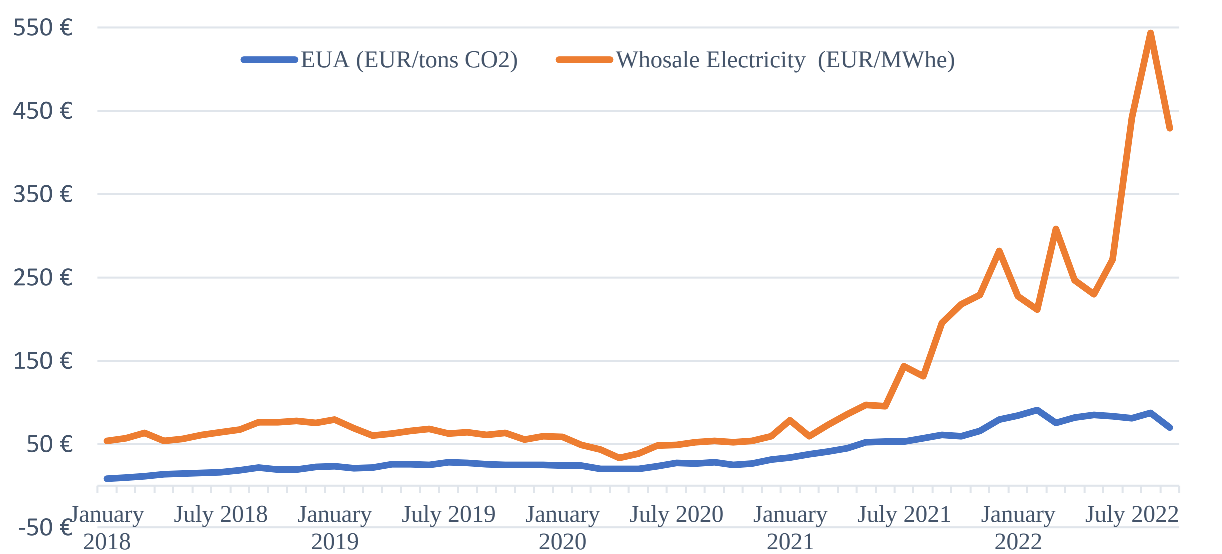
1. A change of winds

Since the beginning of the war in Ukraine, the EU agenda has been impacted by the energy crisis. The EU carbon market is not an exception. Even if there is no doubt about the importance of the on-going revision of the EU ETS Directive (the first ever aligned with a net zero objective), it is not the EU ETS who is stealing the show.

This requires a different approach if we compare the current and the previous EU ETS Revision of 2018, which took place in a different economic context. The environment has changed. If in 2018 the EU Community dedicated a higher degree of attention to the EU ETS, both EU policy makers but also stakeholders focus now on other priorities, looking for short term solutions to acute problems.

This different focus could be justified by the current energy crisis. Indeed, the change from carbon to electricity is not a surprise considering the recent evolution of the wholesale electricity market (see figure 1). While between 2018 and 2022 the EU ETS price has remained around 9 – 90 EUR/tons of CO_2, the wholesale electricity prices have experienced a drastic evolution from 53.49 EUR/MWhe to 543.48 EUR/MWhe in the same period. Although both electricity and carbon prices multiplied by 10, the impact was higher in electricity prices.

Figure 1: CO2 vs Wholesale Electricity Price (€) in the EU 2018 - 2022



Source: Own elaboration based on data extracted from Sendeco2: "CO_2 prices". Available at: https://www.sendeco2.com/es/precios-co2 , and Ember: "Wholesale electricity prices" https://ember-climate.org/data/data-tools/europe-power-prices/ . Prices are average monthly spot prices per tons of CO_2 and MWh sold per time period. For electricity prices, max prices are taken as a reference. Max prices refer to the highest average values of EU in that period.

There is no certitude about how the electricity prices will evolve. This upward trend, which started in January 2021, could remain in the longer term then initially anticipated. EU policy makers have the political responsibility to solve this contingency and the potential negative impact it could create on different segments of society and industrial Europe.

2. Triggering behavioural change

The EU ETS is presented as the main tool of the EU to combat climate change and let's not forget, a well demonstrated instrument to generate funding. While some stakeholders argue that using potential EU ETS revenues is a must to finance the energy crisis in the short term, others are concerned about a potential disruption of a good functioning of the carbon market. Excessive interventions could not only set a precedent but could also undermine EU ETS consistency and credibility in the long term.

There is no doubt that the EU ETS is a tool with great potential to trigger behavioural change. Not only does it show that a progressive, predictable and goal-targeted policy can be effective to reach long term objectives, but it also provides a price signal and affects other EU policies (i.e., triggering innovation). The prioritisation of the energy crisis at the expense of the EU ETS might be justified in the short term. The impact of the EU ETS itself is still real.

Still, this generates serious drawbacks and considerations that we must bear in mind. Under the on-going trilogues, the perception of the EU ETS community is that money has become the real driver of the EU ETS revision and not the climate goals themselves. If this perception is true, we risk creating an instrument that no longer resembles a market driven tool. EU policy makers should understand that the solution to the energy crisis is not in the EU ETS.

3. Issues at stake under the on-going revision

Aiming to not abandon the long-term perspective, there are three main points we see to be relevant to be agreed ahead of the next trilogues, happening on 10 November.

○ The role of non-compliant entities:

The European Parliament adopted on 22 June its position on the revision of the EU ETS Directive. So far, among the three political institutions, it has been the only institution asking to limit access for non-compliant[1] entities in the carbon market (see Annex I). In spite of some EU Member States also advocating for limiting the participation of financial institutions to the carbon market, stakeholders have largely accepted the ESMA conclusions[2] and demand a higher degree of transparency instead.

To ensure sufficient liquidity and to establish a well-functioning mechanism fit for purpose, the market should be safe and attractive for non-compliant buyers, as well as operators. It is therefore important to consider whether the integrity of the EU ETS is sufficiently protected to maintain stability and to ensure investors' confidence[3].

There is a recognition that many players lack financial support, but this does not seem to be caused by the EU ETS itself. Instead, we should further explore and consider the notion that the lack of financial support and additional burden held by operators could be a consequence of increasing production costs due to the current electricity crisis.

○ The extension of carbon price to road transport and buildings:

All three EU institutions are advocating for the extension of carbon pricing to road transport and buildings. Still, there is no consensus about what such an extension should look like. So far, differences remain in the timing of implementation of the to be created new system. These differences include the beginning of monitoring, auctioning, and surrendering of CO_2 certificates (see annex I). The most significant point of contention is still the scope, more specifically the Parliament decision to include only commercial (and not private) entities in the scheme.

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[1] Who do not have an obligation under the EU ETS directive to participate in the scheme nor to surrender CO_2 allowances.

[2] ESMA (2022): Final Report. Emission allowances and associated derivates. 28 March.

[3] ECA (2015): The integrity and implementation of the EU ETS. Special Report. Pp-18.

The European Parliament Plenary voted a last-minute fragile compromise because of concerns about the additional burden the new so-called ETS2 could create for poor households and consumers. The adopted text contains many safeguards and is far from the European Commission proposal presented in 2021.

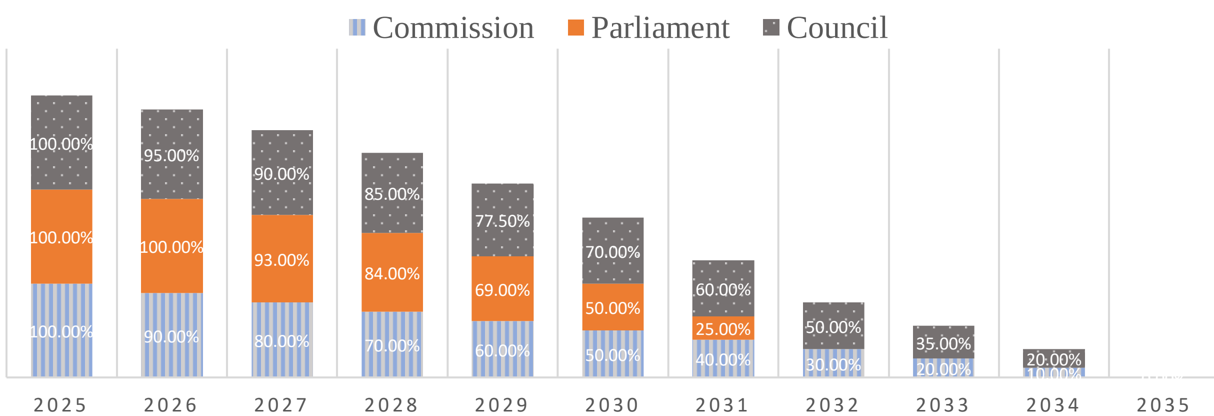
There is a consensus in the EU ETS community that so many provisions may conceive an ETS2 that is difficult to implement. In addition, a price cap of 50 euros/ton of CO2 (as proposed by the European Parliament) may not be incentive enough to ensure an effective decarbonisation of the transport and building sectors.

The Council position also generates some questions. For example, how can we solve the lack of harmonisation across the EU, if fuel suppliers make use of the exemption given when they already subject to a national carbon tax?

- **The EU ETS – CBAM interlinkage:**

Another point of discussion is the application of the carbon border adjustment mechanism (CBAM) and the progressive phase-out of free allocation to goods covered by the new tool. The European Parliament is asking for a later introduction of the tool but at a faster implementation rate (figure 2).

Figure 2: CBAM Factor (%) determining the phase out of free allocation



Source: Own elaboration based on amendments adopted by the European Parliament on 22 June, Council General Approach of 30 June, and European Commission proposal amending Directive 2003/87/EC of 14 July 2021.

According to the European Parliament, CBAM goods should phase out their quotas of free allocation by 2032 as the latest, while both European Council and Commission envisage a full phase-out by 2035.

The European Parliament is also asking to keep free allocation for exports. The Council approach, which may be smoother to implement, is perceived as the most feasible one by the ETS community. It would allow CBAM sectors to better adapt to a new system that has not yet been tested.

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ANNEX - EU ETS Review State of Play & Outline

European Commission Proposal	European Parliament Position	Council Position
Role of non-compliant entities & speculation		
	• (Art 29(aa)): Besides the central and national administration accounts, only regulated entities with past, current, or predictable future EU ETS compliance obligations may hold allowances.	
[Not amended - Current EU ETS Directive] • (Art 29a): Triggering if the CO_2 price for more than 6 months is more than 3 times the average over the 2 previous years, policymakers can consider adding more permits to the system. • EC has to decide if increase is due to market fundamentals. If not, possible measures: • MSs bringing forward auctioning • Up to 25% auctioning of NER	• (Art 29a): Triggering if the CO_2 price for more than 6 months is more than 2 the average over the 2 previous years, policymakers can consider adding more permits to the system. • EC has to decide within 7 days if increase is due to market fundamentals. If not, possible measures: • MSs bringing forward auctioning • Up to 25% auctioning of NER • 100 Million EUAs from MSR.	• (Art 29a): Triggering if the CO_2 price for 6 months is more than 2.5 the average over the 2 previous years. • EC has to publish each month EUA average price of the 6 months and of the 2 years ref period. • No more than 1 triggering within 12 months. Automatic measure: • 75 million EUAs from MSR.

European Commission Proposal	European Parliament Position	Council Position
"ETS2"Carbon pricing to buildings and road transport		

• (Art 30f) Monitoring starting in 2025.
• (Art 30d) Auctioning in 2026.
• (Art 30e) Surrendering in 2027.
• (Art 30c) LRF 5.15% from 2024 & 5.43% from 2028.
	• Monitoring starting in 2024.
	• Auctioning in 2025.
	• Surrendering in 2026:
	  • Commercial transport and building.
	• From 2029:
	  • Private and only after 2026 IA.
	• LRF 5.15% from 2024 & 5.43% from 2028.
		• Monitoring starting in 2025.
		• Auctioning in 2027.
		• Surrendering in 2028.
		• (Art 30e (3)) Suppliers exemption possibility if already subjected to a national carbon tax.
		• (Art 30f) Simplified MRV for regulated entities whose annual emissions are < 1000 tonnes of CO_2.
		• LRF 5.15% from 2024 & 5.43% from 2028.

(Art 30i) EC assessment by 2031 to integrate ETS 2 under EU ETS .	EC assessment by 2031 to integrate ETS 2 under EU ETS .	EC assessment by 2031 to integrate ETS 2 under EU ETS .
• 600 Million EUAs to own MSR in 2026. • Triggering if for more than 3 months, the average price is more than 2 x average price of EUAs during the 6 preceding months. MSR Release 50 million EUAs. • If more than 3 x average price, MSR release 150 million EUAs.	• 600 Million EUAs to own MSR in 2025. • Triggering if for more than 3 months, the average price is more than 2 x average price of EUAs during the 6 preceding months. MSR Release 50 million EUAs. • If more than 3 x average price, MSR release 150 million EUAs. • (Art 30h) Triggering everytime EUA average price over €50. MSR Release 10 millions EUAs.	• 600 Million EUAs to own MSR in 2027. • Triggering if for more than 3 months, the average price is more than 1,5 x average price of EUAs during the 6 preceding months (rule in 2027 and 2028). MSR Release 50 million EUAs. • As from 2029, same as EC. • If more than 3 x average price, MSR release 150 million EUAs.

• (Art 30d) 150 million EUAs to the IF.	• 150 million EUAs to the SCF.	• 150 million EUAs to the SCF.

European Commission Proposal	European Parliament Position	Council Position
EU ETS & CBAM interlinkage		
• Art 10a(1) No free allocation shall be given to installations in sectors or subsectors to the extent they are covered by other measures to address the risk of carbon leakage.	• Art 10a (1a) The production in the Union of CBAM products shall continue to receive free allocation, provided such products are produced for export to 3rd countries without carbon pricing mechanisms similar to the EU ETS.	• Art 10a(1) No free allocation shall be given to installations in sectors or subsectors to the extent they are covered by other measures to address the risk of carbon leakage.
• Art 10 (1a) Free allocation taken out from CBAM sectors to be auctioned and revenues to the Innovation Fund.	• Art 10 (1a) Free allocation taken out from CBAM sectors to be auctioned and revenues to the Climate Investment Fund.	• Art 10 (1a) Free allocation taken out from CBAM sectors to be auctioned and revenues to the Innovation Fund.