ERCST

Roundtable on
Climate Change and
Sustainable Transition

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Reflection Note on "Strategic Challenges to the EU ETS in the long-term" Brainstorm Session (27/09/2019)

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Introduction

With the Phase 4 review, concluded in early 2018, the European institutions attempted to make the EU ETS fit for purpose until 2030. While the implementing process is still ongoing, the EU ETS has to continue to internalise new developments. These developments can be domestic, most notably the recent call by European Commission President-elect Von der Leyen to increase the EU's 2030 climate target and to explore the inclusion of new sectors in the EU ETS. However, they can also be international, such as the ongoing efforts to finalise an agreement of Article 6 of the Paris Agreement, or efforts by other countries to reduce their emissions, including developing carbon pricing initiatives, as well as the level of ambition of other countries.

In light of such developments, it is useful to think about the EU ETS both in the 2030 time-frame, as well as in the longer-term, and explore how it could adapt and address the issues that may emerge. The brainstorm session organised by ERCST on September 27 was intended to discuss, and discover key issues, if any, which would need to be explored, as well as possibly identify work that may needs to be done in the mid to long-term to help the EU ETS to remain resilient, relevant and acceptable.

This note is in no way intended as a summary or conclusions of this session, but should be seen as general reflections from ERCST on the issues that were discussed, and an exploration of their articulation with the EU ETS. All of these issues are important to discuss on their own merits, yet the impending increase of ambition in the EU climate commitment for 2050 and/or 2030 will undoubtedly influence how we perceive and discuss them.

These issues include:

- Review and revision of the EU ETS Market Stability Reserve responding to market developments;
- Addressing competitiveness concerns in the long-term by introducing border carbon adjustments and operationalising Article 30;
- Exploring the role of using domestic offsets through operationalising Article 24a;
- Exploring options for international links with the EU ETS;
- Managing policy fragmentation through effective governance;
- Explore mechanisms to incentivise the deployment of Carbon Dioxide Removal Technologies.

Two other issues, which have not yet been raised during the discussions, but are important to reflect on in future sessions, are:

- the role of the EU ETS in achieving a Just Transition in the EU; and
- the possible consequences of a net-zero target for the EU, or for the EU ETS specifically, on the behaviour of market participants.

1. Review and revision of the EU ETS the Market Stability Reserve

The functioning of the EU ETS has long been impacted by a structural surplus of EUAs, which contributed to prices not representative of long-term scarcity. Some of the main contributors were identified as the effects of the 2008 economic crisis, the existence of important flaws in market design, and the amount of international credits imported during Phase 2 and the first years of Phase 3 of the EU ETS.

The Market Stability Reserve (MSR) was introduced to address both this historical surplus, as well as future occurring imbalances. However, recent analyses have indicated that while the MSR will improve the supply-demand balance in the short term, the surplus on the market will rise again after 2023, due to the effects of overlapping policies. [1]

The MSR has reviews scheduled in 2021 and 2026. Without reopening the ETS Directive, which might happen if the EU were to increase its 2030 ambition, these reviews will be key tool to improve the supply-demand balance, and ensure the proper functioning of the carbon market.

2. Addressing competitiveness concerns in the long-term by introducing border carbon adjustments and operationalising Article 30

Competitiveness concerns have long been a prominent issue in the EU ETS debate and are likely to be an increasingly important issue as scarcity increases. While companies at risk of carbon leakage are currently safeguarded by the system of free allocation, there is a debate if this an indefinite solution to the competitiveness question.

With the new European Commission exploring the introduction of border carbon adjustments (BCAs), the articulation and compatibility between BCAs and the EU ETS needs to be explored. When designing BCAs, several issues should be considered, including:

- Where the BCA is applied (e.g. import vs. export);
- The level of complexity of the BCA (e.g. using aggregated data vs. using product level data);
- The geopolitical and diplomatic impact – as other countries might raise objection to the introduction of BCAs, certain measures could be considered to ensure their support (e.g. exempting poor countries; reinvesting revenue in climate projects in the exporting country);
- How the transition from free allocation to BCAs would happen in practice.

Moreover, any assessment should not be limited to the kind of mechanism best to manage the risk of carbon leakage, but should include assessing *to what extent* protection is necessary. Indeed, all countries are now expected to contribute in reaching the Paris Agreement goals, in the form of nationally determined contributions. Levels of efforts taken in different countries and jurisdictions should be compared and reflected in the overall level of protection provided in the EU.

This debate fits in the wider context of Article 30 of the EU ETS directive, which gives the Commission a mandate to review the support measures for energy-intensive industries in light of climate measures made by other major economies. However, Article 30 is currently not operationalised. Questions that should be discussed include:

- When is Article 30 triggered?
- How do you perform a review under Article 30?

3. Exploring the role of using domestic offsets through operationalising Article 24a

Besides the one-off flexibility for certain Member States to cancel a limited amount of EU ETS allowances and use them to achieve their ESR targets, there currently does not exist any direct links between the EU

[1] A. Marcu et all. 2019 State of the EU ETS Report.

ETS and the ESR. In essence, this means that domestic offsets are currently not recognised under the EU ETS framework.

The directive does foresee the possibility for such a scenario in the future, as captured by Article 24a. Under this article, which has not yet been operationalised, the Commission can adopt measures to issue GHG reduction credits from projects not covered by the EU ETS.

Several motives in favour for operationalising this article can be thought of, such as addressing competitive concerns due to increasing EUA prices, or increasing liquidity as the cap continues to tighten, ensuring proper market functioning. Moreover, contrary to international offsets, allowing for domestic offsets would not be detrimental to achieving overall EU domestic reduction targets.

4. Exploring options for international links with the EU ETS

While the provisions for domestic offsets included in the directive have not been operationalised, and are thus not available for compliance in the EU ETS, the international links were captured in Articles 11a and 25 of the Directive.

Article 11a deals with the use of international offsets from CDM and JI, which were first allowed during phase 2 of the EU ETS. The experience with allowing these offsets into the system has been contentious, and strong qualitative and quantitative limits were introduced for phase 3. In the next phase, international offsets will not be recognised anymore for compliance.

However, the Paris Agreement world is a new world. Article 6, which is still being negotiated and hopefully finalised soon, could be a game changer, potentially alleviating many of the concerns stakeholders currently have. Incentives for re-introducing such an international link to the EU ETS are not dissimilar to those for allowing domestic offsets, and might become more pressing in the future.

Moreover, the EU ETS is no longer the only one in its kind. Increasingly more countries are introducing cap-and-trade systems all over the world. Article 25 reads that the Commission *should* strive towards agreements to mutually recognise and/or coordinate with other emission trading systems. The EU ETS is already linked to the Norwegian ETS, and an agreement to link with Switzerland will enter into force in 2020. These links are beneficial, as they reduce the overall cost for compliance, increase liquidity and address carbon leakage concerns between the two jurisdictions. As new systems are created, it should be continuously explored how the EU ETS should interact with them.

5. Managing policy fragmentation through effective governance

The EU ETS has been portrayed as the cornerstone policy to help the EU economy decarbonise. It builds on the idea of simplicity, introducing a price signal which ensures that emission reductions take place where the costs are lowest.

However, this means that reductions might not take place in all sectors, which EU policy seems to want. Because of this, increasingly more climate measures are introduced, at various levels of policymaking.

This desire for every sector to contribute has also led to the idea that different markets could be created for different sectors or technologies. This would ensure contributions from the specific sector, while also ensuring the sectors' decarbonisation in a cost-efficient way. For example, the recently announced German climate plan includes developing a domestic market for the transportation and building sectors.

Moreover, there are certain technologies that are deemed necessary for the EU to reach is long-term goals, such as carbon dioxide removal technologies. To help mature and deploy these technologies, markets for specific technologies could be developed as well.

This growing fragmentation of Europe's climate policy puts pressure on the EU ETS, and hinders its functioning. An effective governance framework should be created to manage this policy fragmentation, balancing the conflicting desires for cost-effective decarbonisation and contributions from all sectors. The recent call for including the transport sector in the EU ETS, and the mixed reactions that followed, indicate that this will be a difficult task.

The governance of the energy union regulation acknowledges this issue of policy fragmentation to some extent, and has introduced some provisions to assess the effects of other policies on the operation of the EU ETS in article 29. While encouraging, it remains to be seen what effect this will have, and does not solve the root cause of the fragmentation.

6. Explore mechanisms to incentivise the deployment of carbon dioxide removal technologies

Most climate scenarios limiting global warming to below 2°C use carbon dioxide removal technologies (CDRTs) to some extent, in order to neutralise emissions from sources for which no mitigation measures have been identified and, in most cases, also to achieve net negative emissions in scenarios where the temperature goal is initially overshot. With the EU contemplating to increase its 2030 target and aim for carbon neutrality by 2050, frameworks to incentivise CDRTs should be explored, and barriers addressed.

Under the current EU ETS framework, there is an incentive for on-site plant capture under Article 49 of the Commission Regulation 601/2012.[1] This allows installations to subtract those emissions covered by CCS facilities from the total number of allowances they need to surrender. Despite this incentive, the current price of EUAs has not been enough to trigger the necessary level in investments. Moreover, there is no existing incentive for either direct air capture or natural capture under the current EU ETS framework.

Going forward, new incentives under, or next to the EU ETS framework for on-site plant capture could be explored, including the potential introduction of minimum requirements for technologies like CCS. Moreover, an avenue for getting approval to allow voluntary market credits under the EU ETS could be explored under the operationalisation of Article 24a.

Conclusion

ERCST will keep focusing on these issues, looking at ways to introduce or operationalise specific provisions to ensure the EU ETS remains resilient, relevant and acceptable in the long-term.

The work that ERCST intends to undertake will focus on some of the themes identified above. The next meeting will pick up on these ideas but also monitor developments, as the new Commission starts its work and new policy direction and legislative initiatives are unveiled.