

## **Feedback on the Commission's Inception Impact Assessment for the review of the EU Emissions Trading System**

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The European Roundtable on Climate Change and Sustainable Transition (ERCST) welcomes the opportunity to provide feedback on the European Commission's **Inception Impact Assessment (IIA) for the Revision of the EU Emissions Trading System (EU ETS)**. An IIA (or roadmap) identifies key elements and questions that the full impact assessment must address.

Next to increasing the EU ETS 2030 target and Linear Reduction Factor in line with the overall 2030 and 2050 targets, ERCST has put forward 6 issues that should be assessed in the Impact Assessment and addressed through the review:

1. Write a story for the decarbonisation of industry, incl. carbon leakage protection;
2. Address EU ETS policy overlap and supply-demand imbalance, incl. through the MSR and cap review;
3. Assess how to price carbon in other sectors and assess the articulation between ETS, ETD, CBAM and other instruments;
4. Assess the use of flexibility mechanisms such as domestic and international offsets;
5. Assess division and use of auctioning revenues; and
6. Ensure long-term visibility and predictability for market participants.

These 6 core issues form the basis of ERCST's feedback to this IIA.

## **Overarching remarks**

There are two overarching remarks we want to make before assessing the IIA, keeping the 6 issues outlined above in mind.

Firstly, the fact that the IIA outlines in detail which elements of the EU ETS are up for review in the view of the Commission, and which policy options are on the table provides some clarity as to what to expect for stakeholders. However, a sense of the overall direction and objectives of this review is missing.

While the IIA might not be the correct place to outline this, it is necessary to highlight that the IIA focuses on answering very specific questions (e.g. how to change the MSR or how to include sector 'x' in the EU ETS) without there having been an overall discussion on the principles and general policy objectives of the review. Indeed, a public debate is missing on why these questions are asked in the first place, and what the long-term strategic role and vision is for the EU ETS.

Secondly, while we understand that time is short and the Commission is bound by the timeline set out in the European Green Deal, this short timeframe allows for little debate among stakeholders and limits the ability of the Commission to internalise any feedback received.

The fact that the public consultation was already launched during the feedback period for the IIA is testament to this issue. Indeed, normal process describes that the feedback received from stakeholders should inform the Commission's next steps (including the policy options presented in the public consultation).

## **1. Write the story for the decarbonisation of industry**

In order to decarbonise the EU industry, a coherent 'story' needs to be written outlining the policies and supporting tools that will be introduced to ensure this, and what role the EU ETS has to play in this story.

While the IIA makes some passing reference to some elements that should be part of this story (e.g. exploring the use of contracts for difference, incentivising the uptake and deployment of low-carbon technologies through the innovation fund), there is no coherent vision.

Industry's decarbonisation story and its cost should be a key element and central objective of the review. An overarching strategy needs to be developed on the role that different tools and instruments play, including hydrogen, infrastructure requirements, standards, circular economy, CC(U)S and the carbon price.

At the same time, the risk of carbon leakage should be sufficiently mitigated. ERCST recognises that the current system of free allocation and indirect costs compensation is not sustainable in the long-term, and welcomes the Commission's work in designing a Carbon Border Adjustment Measure.

However, the impact assessment should pay sufficient attention to transparently assessing the risk of carbon leakage and the assessment of various options to mitigate this risk. A comparison of the effectiveness of the current measures vs. a CBAM should be assessed, as well as the implications of a potential transition from one measure to the other.

## **2. Address policy overlap and supply-demand imbalance, incl. through the MSR review;**

It is important that the EU ETS will be able to deal with future supply-demand imbalances. The Market Stability Reserve (MSR) is the most important current tool in addressing this, and its mandated review should be fully embedded in the entire ETS review, and not considered separate from other changes made to the EU ETS.

It is important to highlight that the MSR is only a correcting mechanism that kicks in when supply-demand imbalances occur - it does not address the problem at the root cause. The impact assessment should address how the issue of policy overlap can be addressed in the first place, including through limiting the amount of policies put in place, introducing

governance arrangements or exploring an increased role of allowance invalidation by Member States.

The interplay and potential overlap between the EU ETS, the Energy Taxation Directive and a potential CBAM also deserves special consideration.

The appropriateness and current parameters of the MSR should be carefully reviewed as part of the ETS revision. The Commission can learn from the growing body of peer-reviewed literature that is emerging, which potentially indicated to some unintended impacts of the current MSR design, as well as from work carried out by other stakeholders, including ERCST.<sup>1</sup> Moreover, the review should also learn from peer-reviewed assessments

The interplay between a potential one-off rebase of the cap and the MSR should also be assessed.

### **3. Assess how to price carbon in other sectors**

ERCST is a strong proponent of introducing carbon pricing to other economic sectors in the EU. The ultimate goal should be an economy-wide carbon price, increasing the overall economic efficiency of emissions reductions. However, this should occur step-wise, and not disrupt the existing EU ETS system.

We welcome the change in language we have observed in the Commission's communication regarding the potential extension of the EU ETS to other sectors. We are supportive of first examining whether and how carbon pricing, and potentially emissions trading, can be used in reducing emissions in other sectors, and developing the necessary MRV requirements, before considering how the current EU ETS can be linked with the new systems.

The development of a new standalone system, if any, will take a number of years, and the coming years should be used to develop a long-term framework on the role of carbon pricing in the EU's decarbonisation, and a plan and timeline for the ultimate convergence of separate systems.

### **4. Assess the use of flexibility mechanisms**

The IIA must assess the possible benefits and limitations to the use of flexibility mechanisms, both through international and domestic offsets. Several motives in favour of introducing such flexibility exist, including increasing overall efficiency, addressing competitive concerns due to increasing EUA prices, or increasing liquidity as the cap continues to tighten, thus ensuring proper market functioning.

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<sup>1</sup> <https://ercst.org/publication-review-of-the-msr/>

The use of international offsets is a contentious issue with some given the mixed historical experience with the Clean Development Mechanism. However, the Paris Agreement world is a new world. Article 6, which is still being negotiated, could be a game changer, potentially alleviating many of the concerns stakeholders currently have.

If not international offsets, the EU should develop a vision and strategy on future linkages with other ETS schemes, as more countries are introducing cap-and-trade systems. Such links have similar benefits to offsets, as they reduce the overall cost for compliance, increase liquidity and address carbon leakage concerns between participating jurisdictions. Such a vision is urgently needed.

Lastly, the potential benefits from allowing for domestic offsets, as is captured in Article 24a of the Directive, should also be assessed. Domestic offsets' have similar benefits as international, while not being detrimental to achieving the EU's overall GHG reduction targets, which are entirely domestic. Moreover, they can create demand for deploying vital technologies such as negative emissions.

A long-term vision is necessary for the use of flexibilities in the ETS, and their potential benefits should be assessed in the upcoming impact assessment.

## **5. Assess division and use of auctioning revenues**

It is encouraging to see that the IIA makes reference to enhancing some of the Funds and solidarity mechanisms included in the EU ETS in order to address distributional impacts and use auctioning revenues for further investments in climate and energy purposes.

However, a broader discussion and assessment is warranted on the use of auctioning revenues. The implications of using part of the ETS revenues as an additional 'own resource' for the EU should be assessed, as it would put a strain on the auctioning revenues for Member States, of which the large majority is currently used for climate and energy investments or indirect costs compensation.<sup>2</sup>

Moreover, some Member States and stakeholders have come forward with proposals to increase the size of the Funds or change the reference period for the division of auctioning revenues between Member States. The Impact Assessment would benefit from analysing different scenarios to inform the debate.

## **6. Ensure long-term visibility and predictability for market participants**

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<sup>2</sup> <https://ercst.org/publication-2020-state-of-the-eu-ets-report/>

While the IIA mentions that the EU ETS should be brought in line with the EU's 2050 goals, nothing in it points to the fact that the revision will take into consideration the post-2030 time-period, includes assessing the long-term supply-demand balance.

Compliance actors and other market participants have little information as to the post-2030 cap and envisaged role of the EU ETS in decarbonising the EU's economy, hampering their ability to make long-term investment decisions.

On the short term there also exists a lot of uncertainty and lack of predictability for market participants. As a case in point, while it was recently announced that free allocation for 2021 will be delayed due to the fact that the update of the benchmarks was not yet finalised, the IIA raises the possibility to have another revision of those benchmarks in Phase 4.

This uncertainty for compliance actors caused by continuous regulatory changes should be addressed. Taking a longer-term perspective in the revision of the EU ETS could be one part of the solution.