The Commission proposal on the ETS Review: a cool-headed assessment

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Core topics of the ETS Review

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- The general ambition of the revised ETS
- The new free allocation regime and its relationship with CBAM
- The new rules governing the use of ETS revenues
- The new ETS for transport and buildings
- Flexibility

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AMBITION

- New ETS target of -61% (with maritime)
- Relative contribution of ETS sectors to total *EU abatement efforts* under EGD equal to 56.5% (54% under the current Climate and Energy Framework)
- The LRF is increased to 4.2%, up from the current 2.2%. The rebase is calculated so that "*the new linear reduction factor has the same effect as if it would have applied from 2021*".
- The 24% MSR intake rate is maintained until 2030
- A buffer intake rate is introduced whereby when TNAC is between 833 and 1096 million, the MSR absorbs a number of allowances equal to the difference between the TNAC and the lower threshold

Price Outlook

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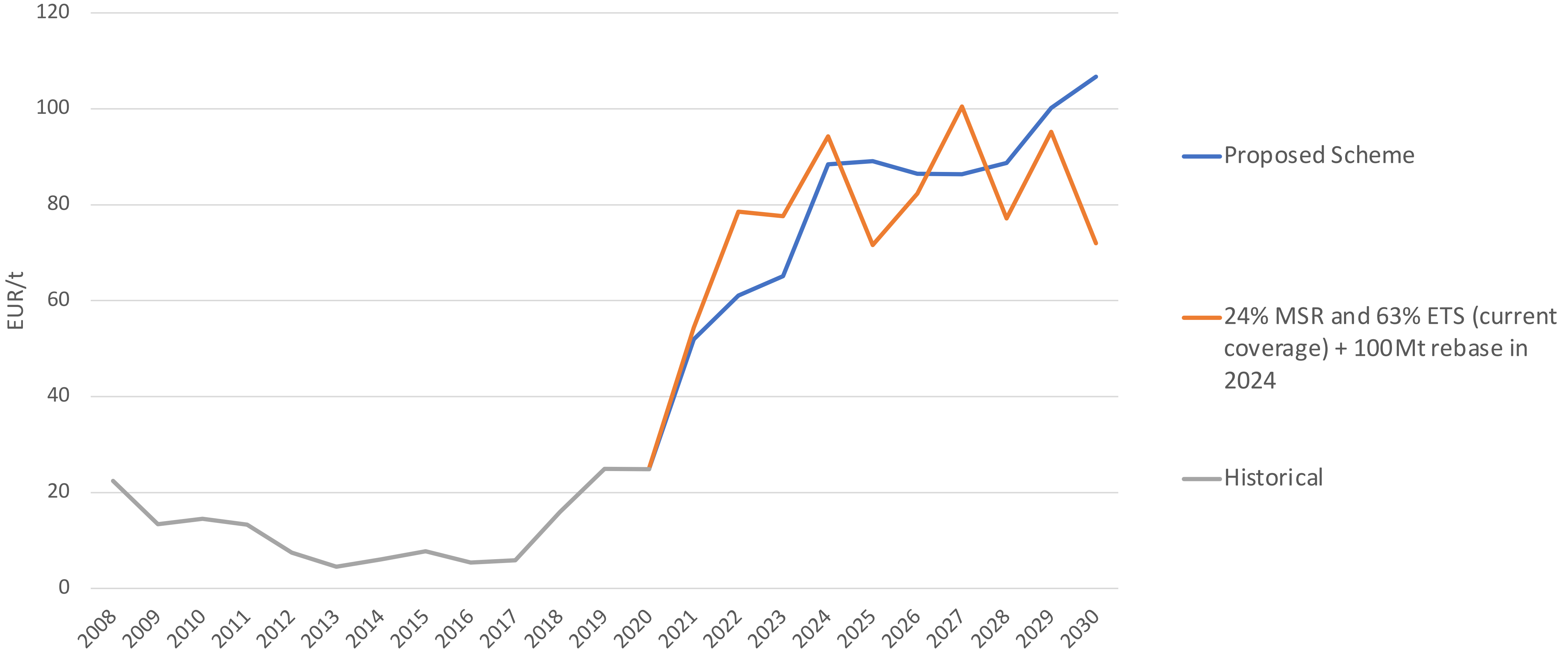
The combination of changes in cap, linear reduction factor and MSR has a bullish impact on the market pre 2025 and bearish beyond 2025



Graph based on calculations by BNEF

MSR Injections

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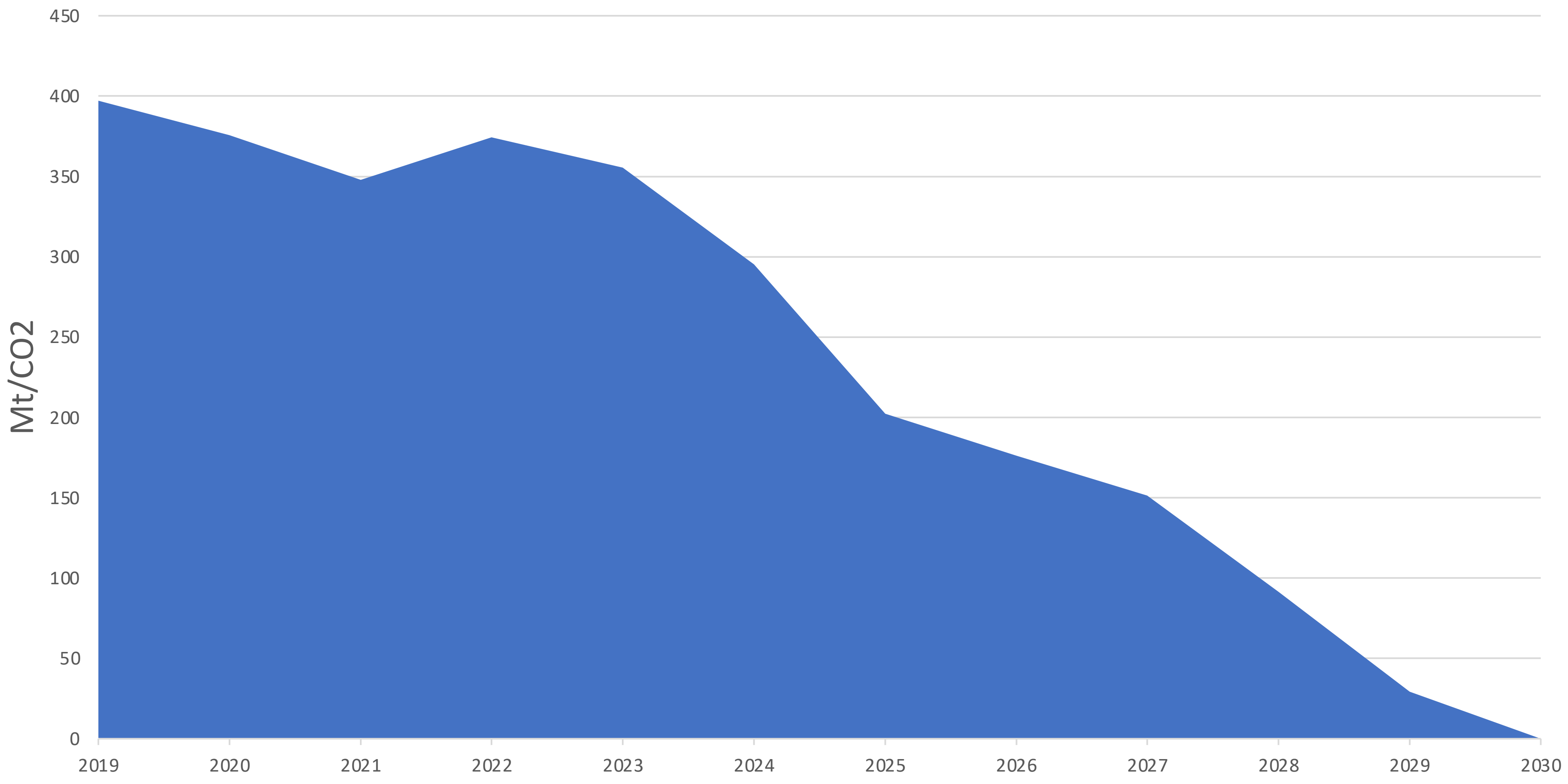

Graph based on calculations by BNEF

Estimated CAP (current scope)

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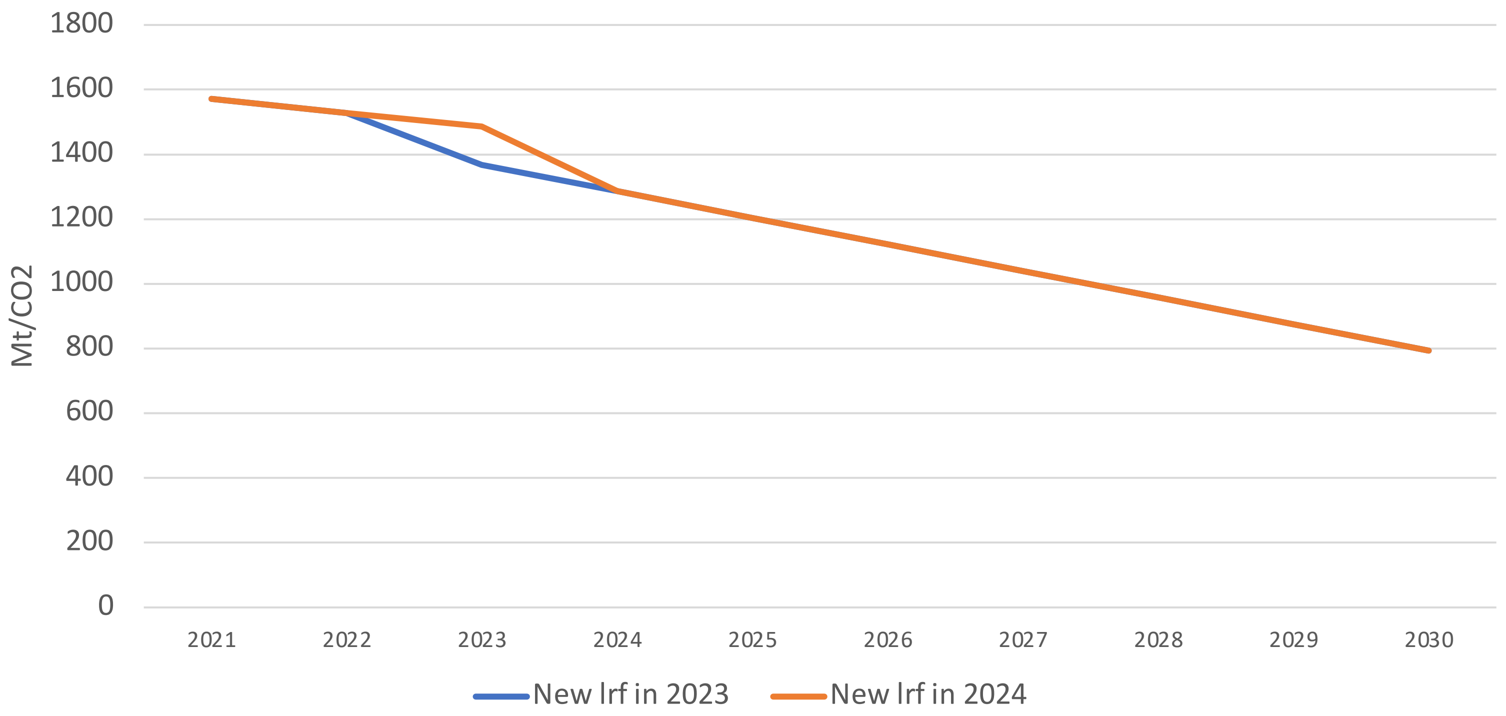

- Implied 2024 lrf = 10.24%
- Annual reduction of 82.1 Mt/CO2
- One-off rebase would be 117.3MtCO2 in 2024 (78.2 in 2023)
- Cap in 2030 = 793.6 MtCO2
- -61.8% for ETS sectors

Graph based on calculations by BNEF

Estimated Cap with maritime

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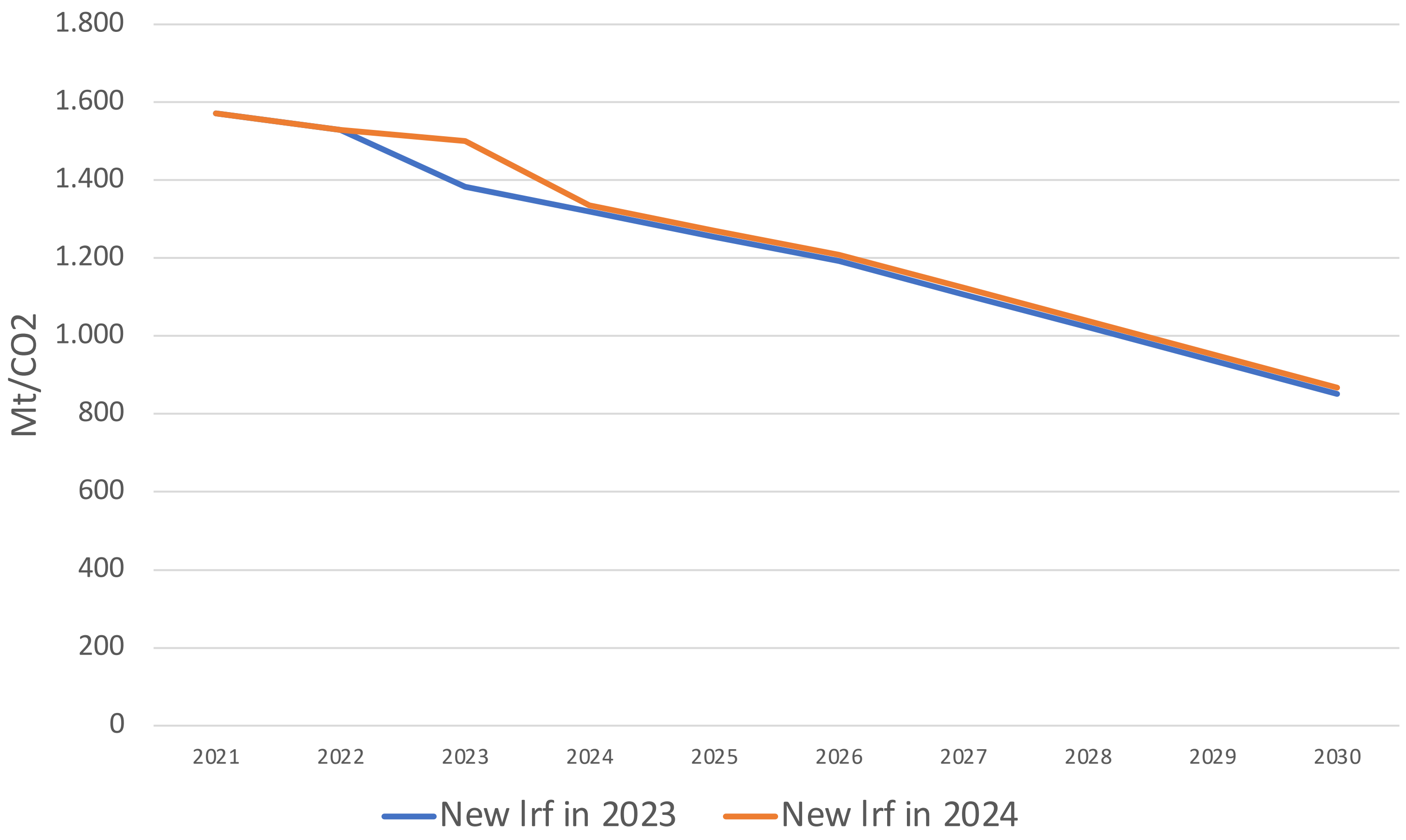

Graph based on calculations by BNEF

- Adding 79MtCO2 from maritime, the cap is estimated at 851MtCO2 by 2030, with a new lrf in 2023 and 867MtCO2 with a new lrf in 2024.
- After maritime is fully phased in, we estimate an annual reduction of 85MtCO2

Some considerations

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- ETS prices on an upward trend since Q4 2020, recently surging to €60
- The carbon footprint of the power sector in the EU rose by 9% year-on-year in Q1 2021
- It is increasingly necessary to look at hedging demand
- Question: does the market need time to factor in the impact of non-priced based policies?

FREE ALLOCATION AND CBAM

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- Free allocation for iron & steel, aluminium, cement, certain fertilizers, and electricity would decline by 10% yearly, starting in 2026, reaching zero by 2035
- Businesses’ main concern regards the absence of *export rebates*
- The Commission maintains that they significantly increase the risk of non-compliance with WTO rules
- The Agreement on Subsidies and Countervailing Measures does not allow for export rebates of regulatory costs
- Rebates also risk undermining the justification of the CBAM as an environmental measure under the exceptions set out in Article XX of the GATT
- EU industrial stakeholders claim that, if well-designed, rebates could actually pass the WTO test, and rely on recent legal opinions that support this argument

Benchmarks

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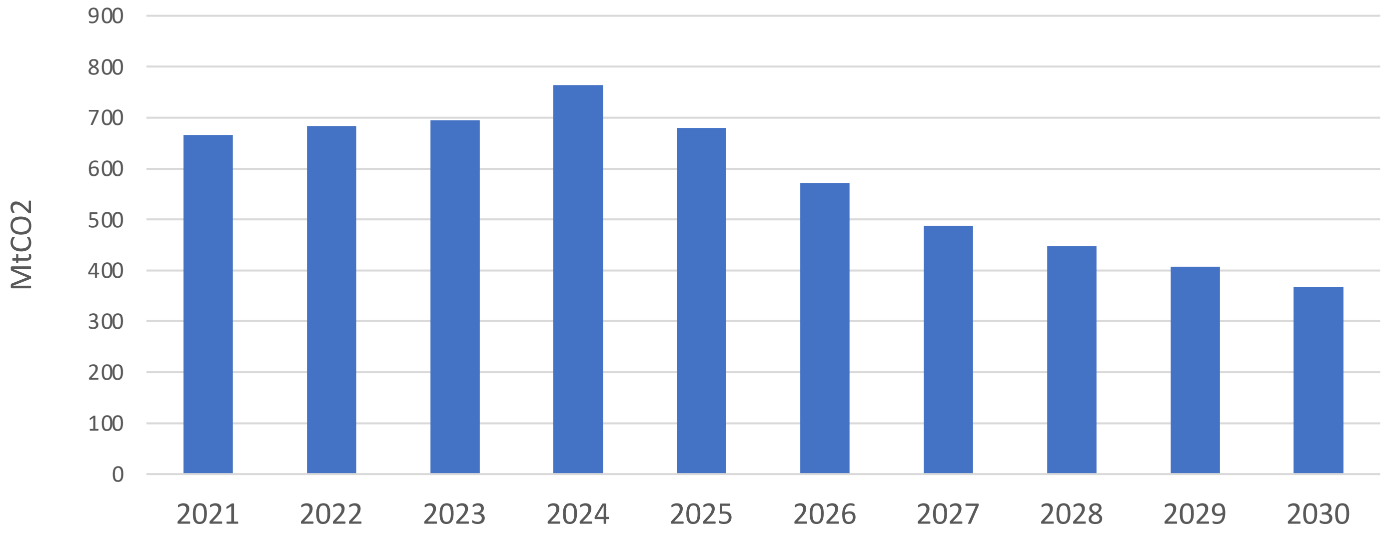
- The proposal increases the maximum update rate of benchmarks to 2.5% as of 2026, up from current 1.6% for sectors with higher innovation uptake
- This should:
    - ensure better targeting of free allocation and a more accurate reflection of innovation and technological progress
    - help avoid the application of the CSCF
- Installations covered by energy audit obligation will be required to implement report recommendation or demonstrate the implementation of other measures leading to equivalent GHG reduction
- The proposal tackled also the flaws of the current benchmarking approach, which grants more allowances to high carbon production methods, thus disincentivizing the switch to low or zero carbon processes

Free Allocation with new lrf in 2024



	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
CSCF AFTER FLEXIBILITY SHARE (%)	100%	100%	100%	100%	91%	83%	79%	75%	70%	64%

- BNEF estimates indicate that the total amount of free allocation slowly increases until 2024 before starting to constantly decrease until the end of the trading period. The CSCF is applied as of 2025, reducing free allocation by 9% in 2025 and up to 36% in 2030.

ETS FOR TRANSPORT AND BUILDINGS

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Carbon pricing in these sectors is made complex by:

- Market failures and non-price barriers to investments in energy efficiency improvements
- Low-price elasticity of energy demand in these sectors
- High upfront costs of substantial emissions abatement options.

This could generate very high EUA prices with little emissions reduction

The proposal takes this concerns into account:

✓ A separate ETS – without free allocated allowances and with its own cap, lrf, and MSR is established for road transport and buildings in 2025, with compliance obligations starting in 2026.

✓ The cap of the new ETS will be set from 2026, alongside a lrf in line with a 45% emissions reduction in these sectors by 2030 compared to 2005.

✓ Cost containment mechanism whereby the MSR releases additional allowances based on the average price level of allowances over a three-month period.

✓ A Climate Action Social Fund financed with 25% of the revenues of the EU ETS to “address social impacts of the extension of emissions trading to road transport and buildings”

USE OF REVENUES

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- Commission proposes to increase the share of auction revenues that Member States are required to spend on climate-related purposes from the current 50% to 100%

Modernisation Fund:

- The proposal to auction an additional 2.5% of the cap risks not to be enough. The MF was originally designed to provide €8.4bn per year, current investment needs under the EGD amount to €300bn.
- Under the proposal, it will not be possible to finance investments in coal-to-gas fuel switching projects through the MF

Innovation Fund:

- Applications submitted for the 1st call requested a total of €22.7bn
- Currently, the IF provides around €18 billion over the entire Phase 4
- The proposal adds 200mln allowances to the Fund and free allocation no longer provided to CBAM sectors will be auctioned, with revenue accruing to the Innovation Fund.

FLEXIBILITY

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- Under the ETS an obligation to surrender allowances does not arise for GHG which are considered to have been permanently stored. The Commission proposes to also consider emissions that are utilised to become permanently chemically bound in a product.
- CO2 storage would not, however, generate *additional allowances*
- The current revision presents the opportunity to allow for the creation of compliance units in the EU ETS through the storage of CO_2 from direct air capture. This will provide one incentive to do direct air capture as well as to create storage capacity.
- This could take the form of a Carbon Storage Obligations (CSO) for distributors of fuels with embedded carbon, i.e. a mandate to geologically store a defined fraction of the carbon imbedded in the they supply.
- CSO would be satisfied by submitting Carbon Storage Unit (CSU), which are created when a tonne of $C0_2$ is permanently geologically stored. These obligations would run in parallel and create complementary flow of funds for storing $CO_{2.}$