FIT FOR 55:
EU-EMISSION TRADING SCHEME (EU ETS I) FOR INDUSTRY AND ENERGY

Proposal COM(2021) 551 of 14 July 2021 **amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading (EU ETS), Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve** for the EU ETS and Regulation (EU) 2015/757

Proposal COM(2021) 571 of 14 July 2021 **amending Decision (EU) 2015/1814 as regards the amount of allowances to be placed in the market stability reserve until 2030**

Proposal COM(2021) 564 of 14 July 2021 for a **Regulation establishing a carbon border adjustment mechanism**

cep**PolicyBrief** No. 5/2022

SHORT VERSION [Go to Long Version]

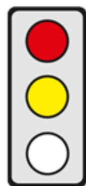
Context | Objective | Interested Parties

Context: The EU aims to reduce its emissions of greenhouse gases (GHG) to net zero by 2050 ("climate neutrality") and by 55% by 2030 as compared with 1990 levels (EU 2030 Climate Target). In order to meet the EU 2030 climate target, the Commission has proposed to revise the EU climate and energy legislation ("Fit for 55" climate package), including the EU ETS Directive [2003/87/EC] on the Emission Trading Scheme for Industry and Energy (EU ETS I).

Aim: The EU ETS I is to be tailored to the EU 2030 climate target, its scope extended, the rules on benchmarks, free allowances and the market stability reserve amended and a carbon border adjustment mechanism (CBAM) introduced.

Affected parties: Energy-intensive industrial sectors and energy producers.

Brief Assessment



Pro

- The tightening of the linear reduction factor (LRF) and the one-off reduction of the cap are basically justifiable as an adjustment to the EU 2030 climate target is necessary.
- An extended modernisation fund will increase the willingness of Member States with low per capita income to support a reformed EU Emission Trading Scheme (EU ETS I).

Contra

- The provisions on reduction of free allowances are misguided because they increase the risk to EU industry of production and emissions being relocated to third countries (carbon leakage).
- The CBAM does not provide does not provide reliable carbon leakage protection solution for EU exporters. Instead, EU companies with carbon leakage risk should receive 100% of the benchmark emissions as free allowances.
- In view of current geopolitical tensions, the EU should base its climate policy on global cooperation instead of conflict-prone unilateral initiatives like the CBAM.

Scope of the EU ETS I [Long Version A.2]

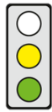
Commission proposal: Industrial installations whose thermal input following GHG reduction falls below 20 megawatts (MW) will remain in the EU ETS I for a further five years. The EU ETS I will be extended to include maritime transport.

cep-Assessment: It is preferable to offer an "opt-in" to all installations that are below the 20 MW, rather than just to those which no longer meet that threshold. Expanding the EU ETS I to maritime transport (see cep**Input** 8/2021) may increase the allowance price and thus the costs to industry and energy producers but the effect is likely to be small.

Authors: Dr. Martin Menner and Dr. Götz Reichert, LL.M. (GWU) | menner@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Telephone +49 (0)761 38693-0 | www.cep.eu

Adjustment of the cap and the Linear Reduction Factor (LRF) [Long Version A.3]

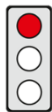
Commission proposal: In order to align the total quantity of EU ETS I allowances with the EU 2030 climate target, the LRF will be increased from 2.2% to 4.2%; a "one-off downward adjustment in the overall quantity" of allowances (cap) will ensure that the new LRF "has the same effect as if it had been applied since 2021" [COM(2021) 551, p. 20].



cep-Assessment: The tightening of the LRF and the one-off reduction of the cap are basically justifiable as the current cap reduction must be adjusted to the EU 2030 climate target. However, as long as not enough countries outside the EU participate in reducing GHG emissions, adequate protection against the relocation of production and emissions (carbon leakage) is essential for EU industry.

Benchmarks and availability of free allowances [Long version A.4, A.5]

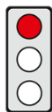
Commission proposal: Ex-ante benchmarks for the number of free allowances to be issued, will be lowered more quickly. Industrial installations that do not implement the recommendations of a mandatory energy audit will receive 25% fewer free allowances.



cep-Assessment: The provisions on reducing free allowances are inadequate because they are based on misconceptions [see Long Version D.1.3]. In addition, by tightening of the LRF and keeping the share of allowances to be auctioned at 57% of the cap, companies will in any case be allocated fewer free allowances overall than they were before. This and the benchmark tightening will increase the risk of carbon leakage.

Carbon Border Adjustment Mechanism (CBAM)

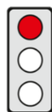
Commission proposal: For GHG emissions from the production of products such as steel that are subject to the CBAM, the amount of free allowances is to be gradually reduced to zero from 2026 until 2035. No exemptions for exporters or export rebates for allowance costs are envisaged by the Commission [see cep**Study** of 13 July 2021]. The European Parliament (EP) proposes to continue granting free certificates for exports for the time being.



cep-Assessment: An expiry of free allowances in CBAM sectors will lead to competitive disadvantages for EU exporters to third countries. The EP proposal to continue to grant free allowances for exports is risky, as the WTO might assess this as an illegal export subsidy and a return to the status quo – with free allowances and without CBAM – might become impossible. Instead of introducing a CBAM, EU companies at risk of carbon leakage should receive a free allocation of 100% of the benchmark emissions.

Market Stability Reserve (MSR) [Long Version A.7]

Commission proposal: The current temporary increase in the percentage of EU ETS allowances from 12% to 24% to be placed into the MSR, when the total number of allowances in circulation exceeds 1096 million, (intake rate) is to be continued beyond 2023 until 2030.



cep-Assessment: It is not necessary to continue to reduce the supply of allowances through a higher intake rate into the MSR, as the allowance prices, which tend to rise anyway due to the faster reduction of the cap, make additional measures to stabilise prices from below unnecessary.

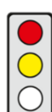
Modernisation Fund and Innovation Fund [Long Version A.8, A.9]

Commission proposal: By 2030, 2.5% of allowances will be auctioned for the benefit of Member States with a GDP per capita of less than 65% of the EU average in 2016 to 2018 and 2% of allowances for the benefit of Member States with a GDP per capita of less than 60% of the EU average in 2013. The Innovation Fund aims to support innovations in low-carbon technologies and processes and will receive an additional 100 million allowances.

cep-Assessment: An extended Modernisation Fund will increase the likelihood that Member States with lower income levels (per-capita GDP) will support a reformed EU ETS I. Increasing the Innovation Fund is in the general interest as private companies are not investing enough in R&D due to a positive externality (spill-over effect).

Use of auction revenues [Long Version A.10]

Commission proposal: Auction revenues that are not used for the Modernisation and Innovation Funds, as "own resources" of the EU budget or for electricity price compensation, will accrue to the Member States. They will be used for decarbonisation but can also be used as income support or to reduce "distortionary taxes" like income taxes.



cep-Assessment: Using auction proceeds for direct income support and to reduce distorting taxes and social security contributions is preferable to financing the own resources of the EU budget or subsidies for the decarbonisation of industry. They will have a positive effect on acceptance and distributive justice as well as on demand and labour supply.

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