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CAN EUROPE POSITION ON THE REVISION OF THE EU EMISSIONS TRADING SYSTEM (ETS)

Climate Action Network (CAN) Europe is Europe's leading NGO coalition fighting dangerous climate change. With over 170 member organisations from 38 European countries, representing over 1.500 NGOs and more than 47 million citizens, CAN Europe promotes sustainable climate, energy and development policies throughout Europe.

INTRODUCTION

EU and Member State climate action remains off track with the international commitments to stop climate change and keep temperature increase to 1.5°C as agreed in the Paris Agreement. The EU Emissions Trading System (ETS) requires a thorough revision and a substantial increase in ambition in order to drive down emissions at a rate sufficiently fast to be in line with the objectives of the Paris Agreement.

The EU ETS, together with the Effort Sharing Regulation (ESR) and the LULUCF Regulation are the EU's main climate instruments implementing the EU's overall climate target. While the LULUCF Regulation mainly deals with net carbon removals from land based sources, the EU's overall emission reductions are divided into a contribution from the sectors covered by the ETS (mainly power, industry and aviation) and the ESR (mainly agriculture, transport, buildings and waste). Under the previous EU climate target of -40% emission reductions by 2030, ETS sectors were set to decrease emissions by 43% compared to 2005 levels while sectors covered by the ESR had to reduce their emissions by 30% compared to 2005 levels. The ESR target in turn is divided into 27 nationally binding targets.

Following the increase of the EU's economy-wide climate target to achieve at least -55% net emission reductions by 2030, compared to 1990 levels, the European Commission is preparing a comprehensive overhaul of key EU energy and climate legislation, including the EU ETS. This offers the unique opportunity to ramp up climate action in all sectors and to fully align EU policy with its global commitments. In light of Europe's historic responsibility and its capacity to act, CAN Europe is calling for the EU to reduce its domestic greenhouse gas emissions by at least 65% by 2030, as compared to 1990 levels.

While this position paper addresses key issues for the revision of the EU Emissions Trading System, please refer to our accompanying position papers with regards to our general demands on the overall EU climate policy architecture, the revision of the EU energy targets and carbon pricing[1].

[1] An overview of CAN Europe's position papers can be found at: www.caneurope.org/news-publications

In order for the EU Emissions Trading System to become fit for the Paris Agreement, it requires a thorough revision of its core features. The following document focuses on our Network's topline demands with regards to i) increasing the system's overall ambition level, ii) strengthening the resilience and responsiveness of the system, iii) respecting the Polluter Pays Principle and iv) funding climate action through the EU ETS.

1. INCREASING THE SYSTEM'S OVERALL AMBITION LEVEL

Ensure that the EU 2030 climate policy architecture is in line with the Paris Agreement

The overall EU climate framework is in urgent need of a substantial revision in order to contribute effectively to the EU's achievement of the Paris Agreement objectives. A sharper increase in ambition is not only necessary to limit temperature increase to 1.5°C, but it can also send a strong market signal and provide necessary regulatory certainty to the market to stimulate and reinforce private investment. In order to reflect its capacity to act and its responsibilities as a major historic emitter, the EU should achieve at least 65% emission cuts by 2030. In turn, the EU's implementing legislative framework needs to be upgraded and each policy piece needs to be brought in line with this higher level of ambition.

CAN Europe calls for the EU to:

- Ensure that the upcoming revision of the EU 2030 climate and energy legislative framework collectively reduces the EU's domestic greenhouse gas emissions by at least -65% by 2030, compared to 1990 levels. For further details on our demands regarding the overall climate policy architecture, please refer to our respective position paper[2];
- Adopt an EU ETS target of at least -70% emission reductions by 2030, compared to 2005 levels;
- Endorse a holistic and comprehensive approach towards the entire 2030 climate and energy framework in order to deliver the necessary emission reductions in a socially fair and cost-effective manner. The EU ETS is but one element in a package and needs to be complemented by a significantly strengthened set of climate and energy policy;
- Safeguard the integrity of the 2030 legislative package, by closing existing loopholes and by ensuring emission trajectories, budgets and targets reflect real emissions.

Rebasing – one-off reduction of the cap to bring ETS emissions closer to reality

The highest abatement potential in a robust ETS reform comes from a combination of rebasing the cap and substantially increasing the linear reduction factor (LRF). The cap, the overall limit of allowances in the system, continues to exceed real emissions, building up a structural surplus which the market stability reserve (MSR) alone cannot fully address. The European Commission estimates that this surplus amounted to around 250 million allowances in 2019,

[2] Position paper on climate policy architecture: https://caneurope.org/position-2030-climate-policy-architecture/

but the current pandemic will increase this surplus even further[3]. In order to ensure that the cap better reflects real emission levels, it needs to be readjusted through a one-off reduction at the earliest date possible.

CAN Europe calls for a rebasing of the ETS cap through a one-off reduction of at least 450 million allowances as early as possible and no later than 2023.

Substantially increase the Linear Reduction Factor

The linear reduction factor (LRF) is the annual rate at which the overall cap for emission allowance decreases. In the current ETS Directive the LRF is set at 2.2% (up from 1.74% in the 2013-2020 period). The LRF needs to be further increased in order to drive down emissions sufficiently and achieve climate neutrality by 2040. Time is of the essence. The later a revised LRF is applied, the higher it has to be in order to meet the desired emission reduction levels in 2030[4]. Therefore, the LRF should be applied as soon as possible and by 2023 the latest and combined with a substantial rebasing effort. Given the timing of the legislative process, we assume that the earliest possible date for an increased LRF to apply is in 2023. Without rebasing or with the new factor applied later, the LRF would need to be considerably higher.

CAN Europe calls on the linear reduction factor (LRF) to be increased as early as possible and no later than 2023 and aligned with an ETS target of at least -70% emission cuts by 2030, compared to 2005 levels. In the absence of rebasing, the LRF would need to be at least 5.8% from 2023 onwards.

Eliminate the structural surplus of allowances

Over the years, a significant surplus of unused allowances has built up under the ETS, amounting to almost 1.6 billion allowances in 2020[5]. Despite the latest revision of the EU ETS leading to a significant reduction in the surplus, it will continue to flood the market up until 2030. Unless addressed, this historic surplus which could further increase due to the consequences of the COVID-19 pandemic, could lead to a situation in which real emissions in 2030 exceed the ETS target. In order to avoid such a situation, rebasing of the cap and the increase of the LRF need to be complemented through a thorough review of the market stability reserve (MSR). Our specific demands on the MSR are detailed in the following section.

[3] For example, Carbon Pulse estimates that the economic downturn contributed to an unprecedented drop in ETS emissions of 13.3% in 2020, compared to 2019 figures: https://carbon-pulse.com/125702/

[4] The 2021 study by the Öko-Institut and WWF, Raising the climate policy ambition of the European Union - Reforming the EU Emissions Trading System offers an overview of different combinations of rebasing, timing and LRF application to achieve up to -70% emission reductions in the ETS by 2030: https://wwfeu.awsassets.panda.org/downloads/making_the_eu_emissions_trading_system__fit_for_55___april_2021_.pdf

[5] https://ec.europa.eu/clima/news/ets-market-stability-reserve-reduce-auction-volume-over-378-million-allowances-between_en

2. STRENGTHENING THE RESILIENCE AND RESPONSIVENESS OF THE SYSTEM

The ETS remains alarmingly vulnerable to external shocks. After the 2008 economic crisis demand for emission allowances plummeted and created a giant surplus in the market which kept the carbon price extremely low for a decade. The current pandemic-induced economic downturn will further increase this surplus. In order to support the system's resilience and adaptiveness, the following elements should be reinforced through the coming revision: strengthening the market stability reserve (MSR), introducing a steadily increasing carbon floor price and making unilateral national cancellations of allowances mandatory.

Strengthening the Market Stability Reserve (MSR)

The market stability reserve (MSR) which became operational in 2019 is a permanent mechanism to address the surplus of allowances in the EU ETS by absorbing unused allowances and keeping them off the market. It responds to imbalances in supply and demand and is activated when specific thresholds are met. Every year, if the surplus of allowances measured as the total number of allowances in circulation (TNAC) is greater than 833 million, a certain percentage of the TNAC, which is determined by the MSR intake rate, will be placed in the reserve. Between 2021 and 2023, the MSR intake rate is 24%. From 2024 onwards, a lower intake rate of 12% applies. In case the surplus in the system falls below 400 million, the MSR will release allowances back into the market.
The current rules of the MSR require further strengthening in order to fully address the systemic surplus, to ensure the EU carbon market can accommodate the need to phase out coal and lignite in the power sector by 2030, and to support the ETS in dealing appropriately with external demand shocks.

CAN Europe calls for the strengthening of the market stability reserve (MSR) in the following ways:

- Increase the intake rate of the MSR to 36% and apply this increased rate up until 2030. Without a higher intake rate, there is a risk that a significant surplus will prevail until 2030[6];
- Apply a linear reduction to zero by 2030 to the upper and lower thresholds of the MSR as early as possible;
- Ensure that allowances that are kept in the MSR for more than three years are automatically cancelled.

[6] Sitra (2019). The role of the EU ETS in increasing EU climate ambition. https://media.sitra.fi/2019/10/07112628/the-role-of-the-eu-ets-in-increasing-eu-climate-ambition.pdf

Establish an EU-wide and steadily increasing Carbon Floor Price

In order to prevent the EU carbon price from dropping to historic lows, a carbon price floor should be introduced within the EU ETS. It will offer all market participants planning security, predictability as well as maintained application of the Polluter Pays Principle. The price floor should start at 40 EUR/tCO2e and increase over time, aiming at reflecting the societal cost of carbon, estimated at 180 EUR/tCO2e[7]. If such a price floor cannot be realised in the whole EU ETS within a reasonable amount of time, a group of EU member states should go ahead and introduce the instrument in the framework of a forerunner alliance. All revenues from a carbon floor price should serve to fund further climate action (see point 4 below).

CAN Europe calls for the introduction of a progressively increasing EU-wide Carbon Floor Price to reflect the societal cost of carbon as early as possible.

Address waterbed effects through unilateral cancellation of allowances

The market stability reserve might not be responsive enough to address a possible surge of unused allowances stemming from increased climate action at member state level. National measures such as shutting down of coal power plants due to coal phase-out decisions can free up billions of allowances which can have a dampening effect on the EU-wide carbon price. In order to ensure that progressive measures in individual member states do not weaken the ETS price signal, it should be mandatory for member states to unilaterally delete an amount of allowances equivalent to the emissions saved by the national measure.

CAN Europe calls for unilateral cancellations of allowances to be made mandatory in response to national measures impacting the EU carbon market.

3. RESPECTING THE POLLUTER PAYS PRINCIPLE

Abolish free allowances and move towards 100% auctioning

Currently, 94% of industrial emissions under the ETS are still believed to face significant risk of carbon leakage. Industry receives the bulk of its allowances for free, eliminating the urgently needed incentives for industry to transform towards climate neutrality and resource efficiency[8]. Recently, the EU Court of Auditors has recommended to reform this system of free handouts. Given the lack of evidence of climate policy-induced carbon leakage, the current handout of free allowances to industry and aviation operators needs to stop. Polluting for free in times of a climate crisis is unacceptable. The ETS should shift towards 100% of allowance auctioning across all covered sectors. If a carbon border adjustment mechanism (CBAM) were to be implemented, this must be developed as an alternative to free emission allowances and there should be no overlap between the two.

[7] https://www.umweltbundesamt.de/en/press/pressinformation/high-costs-when-environmental-protection-is
[8] https://www.eca.europa.eu/Lists/ECADocuments/SR20_18/SR_EU-ETS_EN.pdf

CAN Europe calls for the immediate phase-out of free allocations and the imminent shift towards 100% auctioning in all sectors in order to ensure a full application of the Polluter Pays Principle and to provide the necessary market signals to drive interest from private financing and ensure policy coherence. Operators should provide evidence for the causal link between EU climate policy and carbon leakage before targeted support can be considered. Also when a Carbon Border Adjustment Mechanism (CBAM) is adopted, free allowances need to cease immediately.

Ensure coherence with Carbon Border Adjustment Mechanism (CBAM)

The European Commission has proposed to introduce a CBAM to ensure international action on climate and to address a possible increased risk of carbon leakage due to the necessary revisions to the ETS to align it with the EU 2030 climate target. The European Commission has also been very clear from its first communication of its intention to develop a CBAM that it would be WTO compatible which means applying the environmental exception allowed in WTO Article XX. However, as carbon leakage remains theoretical, it does not justify an increase and possible protection of EU industry. . Given the long-standing weaknesses of having free emission allowances in the ETS, CAN Europe calls for several aspects to ensure coherence and a reinforcing relationship between the ETS and the CBAM:

CAN Europe calls for:

- No overlap between free allowances and the CBAM. The application of CBAM to ETS sectors should automatically cancel free allowances for all sectors.
- The introduction of a CBAM must not water down the overall cap on emission allowance or the need to further strengthen the annual reduction of total permits, in line with the EU's climate neutrality objective and an updated EU 2030 climate target.
- Export rebates should be excluded from the mechanism as this could encourage differentiated production for domestic and export markets, leading to exporting of higher carbon products. Export rebates would not be coherent with higher EU climate ambition and the drive to encourage higher climate ambition globally. The introduction of CBAM must not disadvantage new climate neutral production in Europe and must not interfere with EU or member states support instruments to incentivize climate neutral production. In particular, if export rebates are introduced, they must be equally applied to emission intensive and climate neutral production.

Fully include emissions from international aviation and shipping

Today, emissions from international maritime and aviation are not sufficiently regulated. In theory, all flights from within the European Economic Area (EEA) are covered by the system in addition to extra-EEA flights with either departure or destination in the EEA. Since 2012 however, the EU ETS does not apply 'temporarily' to these extra-EEA flights, in light of attempts from the International Civil Aviation Organization (ICAO) to establish a global regime to reduce aviation emissions (the so-called stop-the-clock-derogation). In addition, the non-CO2 impacts of aviation have still not been addressed by the EU, despite increasing the climate impact of aviation by a factor of three compared to CO2 alone, according to EASA's latest report published by the European Commission. Emissions from international maritime emissions have so far not been included into the EU ETS and remain largely unregulated.

Emissions from both incoming and outgoing vessels to EU ports should be fully included in the EU ETS (so-called 'full scope inclusion').

CAN Europe calls for the EU ETS to fully cover and apply to all emissions stemming from intra- and extra-EU aviation and navigation[9]. In particular, we call for:

- Aviation and shipping emissions to be subject to the same 2030 emissions reduction target as the other ETS sectors;
- Immediately abolish the handout of free allowances to the aviation sector and apply 100% auctioning to the newly integrated shipping sector;
- Applying a multiplier factor to aviation emissions given their non-CO2 impacts;
- Apply complementary instruments to drive down emissions in aviation and shipping, including a carbon emissions tax, removing the respective exemptions in the EU Energy Taxation Directive, an EU-wide ticket and kerosene tax for aviation and a carbon intensity target for maritime sectors.

Eligibility of biomass in the EU ETS and ESR

Biomass is treated as if it were a carbon neutral energy carrier, but that is demonstrably not the case. While the emissions related to the decline in carbon sequestration from tree-cutting are accounted for in the land sector, this is done badly meaning that many emissions go unaccounted. Furthermore, LULUCF accounting is not a good tool to measure emissions from biomass burning, and does nothing to calculate the carbon impact of the biomass burnt and whether it is better or worse than burning fossil fuels. Indeed, according to a recent JRC report[10], different types of biomass currently incentivised by EU policy increase emissions compared to fossil fuels, and create tension in the use of biomass as a food, fibre or fuel, leading to habitat destruction, land use change and biodiversity loss. It is therefore essential that the sustainability criteria for biomass in the EU Renewable Energy Directive be strengthened, and for biomass burnt for energy under the ETS and ESR only to be considered carbon neutral if it complies with those criteria.

CAN Europe demands that the net emissions from the use of biomass are accounted for under the EU ETS and that biomass use is subject to comprehensive sustainability criteria and robust and transparent carbon accounting.

4. FUNDING CLIMATE ACTION THROUGH THE EU ETS

In order to accelerate the EU's economic transformation and to achieve at least 65% overall emission reductions by 2030 and climate neutrality by 2040, national revenues from auctioning ETS permits as well as the various funds and investment instruments under the EU ETS must boost climate action, be dedicated to action in the EU, deliver on the EU's international climate finance commitments and must not support technological lock-in that is incompatible with the EU's long-term objectives.

[9] This would entail that the ETS scope would cover 50% of all outbound and inbound ship journeys to and from the first port of call outside the EU and for aviation all outbound journeys.
[10] JRC (2021). The use of woody biomass for energy production in the EU. https://publications.jrc.ec.europa.eu/repository/handle/JRC122719

CAN Europe calls for the ETS revenue use and the system's funding instruments to adhere to the following main principles:

- All revenue the ETS generates must be earmarked in a redistributive way to enhance climate action and support a just transition for communities, dedicated to climate action domestically and to international climate finance. In the EU, priority should be given to investments for energy savings, sustainable renewable energy technologies including grid connections and storage, new climate neutral processes for the basic industries and renewable hydrogen production and infrastructure as well as projects which address climate action and simultaneously reduce inequality by redistributing revenues fairly - such as those promoting community energy and energy efficiency. The energy efficiency first principle should guide investment decisions and biomass should be subjected to strict sustainability criteria and robust accounting obligations in order to receive funding. Revenues are also needed to ensure the EU delivers on international climate finance commitments, with particular attention to adaptation, resilience building and finance for loss and damage;
- No financial support shall be given to fossil fuel based or nuclear energy production, including through the Innovation and the Modernisation Funds[11];
- Full transparency and opportunity for public consultations shall be ensured in the selection and implementation of all projects and investments, as well as in the development of selection criteria and the decision-making processes. All information must be publicly available (with an official English translation) on a dedicated website including project documentation, decisions, and monitoring reports. Annual reports on results of the funds shall be presented to European Parliament. For all financial support received, full and independent monitoring, reporting and verification shall be ensured. The Commission should make efforts to improve transparency of, and public accountability for, revenue use by Member States, as well as follow-up cases of incomplete, inconsistent or ambiguous data on revenue use.

[11] See also CAN Europe (2021) Briefing on How the EU Modernisation Fund can be a driver for the fossil-free energy transformation: https://caneurope.org/content/uploads/2021/04/Policy_briefing_Modernisation-Fund_April_2021.pdf