Review of the EU ETS

'Fit for 55' package

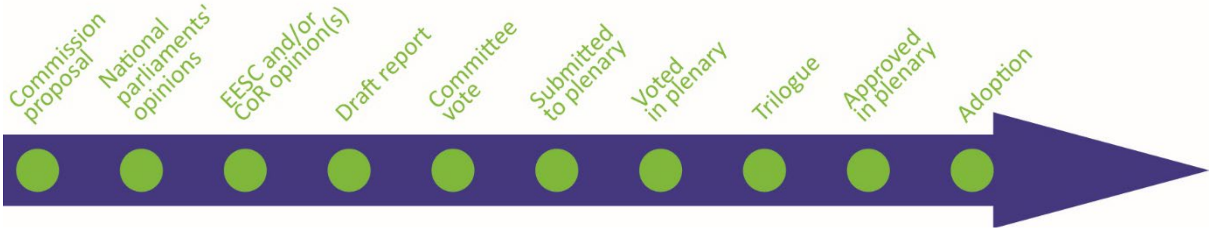
OVERVIEW

As part of the 'Fit for 55' package, the European Commission presented a legislative proposal to review the EU Emissions Trading System (ETS). The aim of the review is to align the EU ETS Directive with the EU targets set out in the European Climate Law. To this end, the amount of emission allowances would be reduced, fewer allowances would be allocated for free, and the ETS would be extended to maritime transport. A separate new emissions trading system would be established for fuel distribution for road transport and buildings.

In the European Parliament, the proposal was referred to the Committee on Environment, Public Health and Food Safety (ENVI), with Peter Liese (EPP, Germany) as rapporteur. The Parliament and the Council adopted their respective positions in June 2022 and reached a provisional trilogue agreement in December 2022. The file was subsequently split into two parts, with the monitoring, reporting and verification of maritime GHG emissions treated separately. The legal acts were published in the Official Journal on 16 May 2023 and enter into force on 5 June 2023.

Proposal for a directive amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757

Committee responsible:	Environment, Public Health and Food Safety (ENVI)	COM(2021) 551 14.7.2021
Rapporteur:	Peter Liese (EPP, Germany)	
Shadow rapporteurs:	Mohammed Chahim (S&D, the Netherlands) Emma Wiesner (Renew, Sweden) Michael Bloss (Greens/EFA, Germany) Alexandr Vondra (ECR, Czechia) Danilo Oscar Lancini (ID, Italy) Silvia Modig (The Left, Finland)	2021/0211A(COD) 2021/0211B(COD) Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Procedures completed.	Directive (EU) 2023/959 Regulation (EU) 2023/957 OJ L 130, 16.5.2023, pp. 105–114; 134–202	



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PE 698.890 – May 2023

Introduction

On 14 July 2021, as part of the 'Fit for 55' package, the Commission presented a legislative proposal to review the EU ETS. The review aims to align the ETS with the EU target set in the European Climate Law to reduce net GHG emissions by 55 % by 2030, compared to 1990 levels. It is complemented by a review of the two other main elements of EU climate legislation, the Effort-Sharing Regulation (EU) 2018/842 and the Land Use, Land-use Change and Forestry Regulation (EU) 2018/841, as well as other energy and climate legislation.

Carbon pricing

A price on GHG emissions is an incentive for economic actors to reduce their emissions and invest in low-carbon technologies. It puts a price on externalities, i.e. costs on others or damages, which are not reflected in the prices of goods and services. The social cost of carbon is an estimate of the economic costs of emitting one tonne of CO_2 into the atmosphere, and thus the benefits of reducing emissions. In the United States, a social cost of carbon of US$51 is used for policy-making. Companies and institutional investors use fictional shadow carbon prices in their investment decisions to account for externalities and assess business risks related to carbon pricing.

There are two principal approaches for putting a price on GHG emissions:

- a **carbon tax**, which fixes the price of emissions and lets economic actors decide about the quantities;
- **emissions trading** (cap and trade) systems, in which the maximal quantity of emissions (the cap) is fixed and the price for emission is set by the market.

In principle, trading of emissions should lead to cost-effective emissions reductions, because companies will invest in low-carbon technologies that reduce emissions as long as the price is lower than the market price for emissions. However, regulations to reduce GHG emissions induce an implicit carbon price, i.e. the cost of complying with the regulations, which may exceed the market price.

Carbon leakage occurs if companies transfer their production to other countries with no or less stringent climate regulation to avoid costs related to a carbon price. As a result, global emissions would increase. This issue can be addressed by lowering the carbon price for producers that are confronted with foreign competitors who face lower carbon costs, through trade policy, or by introducing a carbon border adjustment for imports.

In 2021, there were 24 emissions trading systems in operation worldwide, covering 16 % of global emissions. Another 22 governments are developing or considering an emissions trading system.

Article 6 of the Paris Agreement provides for international cooperation, such as linking emissions trading systems, and for international carbon markets, where credits for emission reductions can be traded between countries. In November 2021, the COP26 conference adopted the rulebook for Article 6, enabling the establishment of international carbon markets.

In 2016, the International Civil Aviation Organization decided to establish a global market-based measure in the form of the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA). To compensate for international civil aviation's CO_2 emissions above 2020 levels and achieve carbon-neutral growth, emitters (i.e. airlines) would buy emissions units (representing 1 tonne of CO_2) from green projects. After a voluntary pilot phase (2021-2023) and first phase (2024-2026), participation will become mandatory for all signatory states (except certain developing countries) in phase II (as of 2027). Eighty-eight states, including all EU Member States, have been participating in CORSIA from its outset.

Brief history of the EU ETS

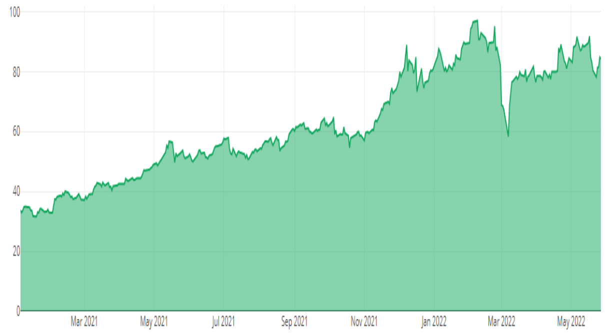
The EU ETS started in 2005 with a 3-year pilot phase, and phase 2 (2008-2012) coincided with the first commitment period of the Kyoto Protocol. The ETS has covered aviation since January 2012.

Phase 3 (2013-2020) broadened the scope of the ETS to more sectors and gases, introduced a single EU-wide cap, made auctioning the default method for distributing allowances, and harmonised the rules for free allocation. By 2020, emissions covered by the ETS decreased by 41 % compared to 2005, a significant over-achievement of the 2020 target of a 21 % reduction under phase 3 of the EU ETS.

The 2007-2012 financial crisis depressed the demand for emission allowances, while the supply remained fixed and was further expanded through international carbon credits. This surplus caused a collapse in the price for European emissions allowances (EUA) from €30 in 2008 to €2.75 in April 2013. To reduce the surplus and align the supply of allowances with the demand, a market stability reserve (MSR) started operating in January 2019.

Phase 4 of the EU ETS started in 2021, with a cap that is aligned with the previous 2030 target to reduce EU GHG emissions by 40 %, compared to 1990 levels. The legislative proposal in the 'Fit for 55' package to review the ETS aims to align emissions trading in phase 4 with the 2030 target set in the European Climate Law, of reducing net emissions by 55 %, by lowering the cap, including further sectors and improving the functioning of the ETS.

Figure 1: Price of EU allowances (futures, €/t CO_2e)



Source: Ember carbon price viewer.

From January to December 2021, the EUA price more than doubled, from €34 to above €80. A report by the European Securities and Markets Authority finds that the market functions as expected: non-financial entities buy EUA futures to hedge their carbon price exposure, while financial entities, acting as intermediaries, facilitate trading and provide market liquidity.

Switzerland's emissions trading system has been linked to the EU ETS since 1 January 2020. The United Kingdom stopped participating in the EU ETS with the end of its EU membership, and established its own emissions trading scheme. A recent discussion paper by the City of London Corporation points to the close similarities between the EU and UK emissions trading systems and highlights the potential benefits of closer cooperation between the two systems.

Existing situation

Directive 2003/87/EC established the EU ETS, a 'cap-and-trade' policy tool for reducing GHG emissions in a cost-effective way. The system operates in all EU Member States, as well as Iceland, Liechtenstein and Norway, regulating around 10 000 installations, including power plants and energy-intensive industrial installations, and covering over 40 % of the EU's GHG emissions. Since 2012, the system also regulates aircraft operating within and between these countries.

The EU ETS is a market-based mechanism, which sets a fixed upper limit for GHG emissions (the 'cap'), which is divided into emissions allowances, each giving permission to emit one tonne of CO_2 or CO_2-equivalent[1] (CO_2e). The emissions allowances are partly auctioned and partly distributed for free to industries at risk of carbon leakage; the allowances can subsequently be traded between the installations.

Each Member State must ensure that, by 30 April every year, each regulated installation surrenders a sufficient number of allowances to balance its total emissions from the preceding year. Any unused allowances remain valid and can be used in subsequent years, while the total cap decreases every year to provide an incentive to reduce emissions.

The ETS Directive was last amended in 2018 by Directive (EU) 2018/410, which set the parameters for phase 4 of the EU ETS (2021-2030). The ETS contributes to the EU's previous 2030 target of reducing GHG emissions by 40 % compared to 1990 levels, by reducing emissions in the ETS Directive sectors by 43 % compared to 2005 levels. To this end, the annual linear reduction factor for GHG emissions increased from 1.74 % to 2.2 %. From 2021 onwards, 57 % of allowances are auctioned.

Market stability reserve

Decision (EU) 2015/1814 established the market stability reserve, which started to operate in January 2019 as a response to the over-supply of allowances since 2009, a result of the economic crisis and high imports of international credits, which led to lower carbon prices. The MSR allows for better matching of the supply of allowances to be auctioned with demand. Under the revision of the EU ETS in 2018, the MSR intake rate (the percentage of the total number of allowances in circulation which is put in the reserve) until the end of 2023 was doubled from 12 % to 24 %, and the minimum amount of allowances placed in the MSR was doubled from 100 to 200 million. Moreover, from 2023 the allowances held in the MSR above the total number of allowances auctioned during the previous year should no longer be valid.

Sectors at risk of carbon leakage (determined by their intensity of trade with third countries, emission intensity and the share of carbon cost in gross value added) receive up to 100 % of their allowances for free until 2030. Other sectors, at lower risk of carbon leakage, receive up to 30 % of their allowances for free, with the amount decreasing after 2026 to reach zero in 2030. The list of installations eligible for free allocation of allowances is decided for a period of 5 years.

The level of free allocation is based on benchmarks, so that less efficient installations receive only as many allowances as the 10 % most efficient installations would need for the same amount of production; benchmarks are to be updated twice in phase 4 to adjust for technological progress and to avoid windfall profits. The allocation of allowances may be adjusted every year, based on a rolling average of 2 years, if production has decreased or increased by more than 15 %. If not enough free allowances are available, a cross-sectoral correction factor will be applied to reduce the amount of free allocations for all installations by the same percentage.

Member States are responsible for issuing emissions allowances and ensuring monitoring and reporting of the recipients' GHG emissions; they must use at least half of the revenues from auctioning for climate-related purposes. Two new funds have been established to support energy-intensive industrial sectors and the electricity sector in their innovation and investment challenges in the transition to a low-carbon economy. The Innovation Fund supports innovative low-carbon technologies in energy-intensive industries, carbon capture, use and storage of renewable energy, and energy storage. The Modernisation Fund supports the modernisation of the electricity sector and energy systems in 10 lower-income EU Member States.

In preparation of carbon pricing for maritime transport, Regulation (EU) 2015/757 introduces a system for monitoring, reporting and verification of CO_2 emissions (MRV Regulation) from all ships calling at EU ports. It is being amended to align it with the global data collection system of the International Maritime Organization (IMO).

Parliament's starting position

In its resolution on the European Green Deal of 15 January 2020, the European Parliament called on the Commission to review the ETS Directive rapidly to align it with the increased GHG targets, including revision of the linear reduction factor and the rules for allocation of free allowances, and to address the potential need for a carbon floor price. It opposed the inclusion of road transport in the EU ETS and expressed reservations regarding the inclusion of the buildings sector. On the other hand, it supported the inclusion of the maritime sector.

On 16 September 2020, the Parliament voted to amend the MRV Regulation to require shipping companies to reduce their annual average CO_2 emissions relative to transport work by at least 40 % by 2030, and to amend the ETS Directive to include maritime transport from 2022.

European Council starting position

The conclusions of the December 2020 European Council meeting invited the Commission to explore ways to strengthen the ETS system, while maintaining its integrity and taking distributional concerns and energy poverty into account. They suggested that upcoming legislation should address the issue that beneficiaries of the Modernisation Fund do not receive revenues that are equivalent to the costs paid by ETS installations in those Member States.

Preparation of the proposal

A public consultation (online questionnaire with 29 questions) on the revision of the EU ETS was held from 13 November 2020 to 5 February 2021. There were 493 responses, with most coming from business associations and companies (70 %), followed by NGOs (10 %) and EU citizens (7 %).

The proposal is accompanied by a detailed impact assessment (IA). The IA addresses the measures to revise the EU ETS in a cost-effective way and in line with the target set in the European Climate Law, while accounting for the need for just transition and for all sectors to contribute to the EU climate targets. Specifically, the IA identified and assessed policy options for different elements in the following areas: strengthening the ETS; extending emissions trading to maritime emissions; extending emissions trading to buildings and road transport or all fossil fuels.

Strengthening the ETS covers three main options regarding a tighter emissions cap, a review of the MSR, a more targeted framework for carbon leakage (while incentivising innovation), and a review of the Innovation Fund. The IA analyses four main options for extending the EU ETS to maritime transport, the preferred option being integration into the current system. For extending emissions trading to other sectors, the two main options identified by the IA are to have a separate ETS either for buildings and transport, or for all fossil fuel combustion emissions not covered by the EU ETS.

The Commission's Regulatory Scrutiny Board adopted a positive opinion with reservations on the draft impact assessment report in April 2021, asking the Commission to make it less technical and more accessible to inform the key policy choices, highlight links with other 'Fit for 55' initiatives, and better justify why the ETS should be extended to the maritime sector and to transport and buildings.

EPRS has prepared an initial appraisal of the Commission's impact assessment.

The changes the proposal would bring

The Commission proposal to amend Directive 2003/87/EC concerns the ongoing phase 4 of the ETS (2021-2030). It consists of five main elements:

1. a reduced cap and a more ambitious linear reduction factor for GHG emissions;
2. revised rules for free allocation of allowances and the market stability reserve;
3. extension of the ETS to maritime transport;
4. a separate new ETS for buildings and road transport;
5. an increase in the Innovation and Modernisation Funds and new rules on using ETS revenues.

In addition, the Commission presented a legislative proposal to amend the MSR Decision (EU) 2015/1814 to strengthen the MSR, and two legislative proposals to amend the ETS Directive 2003/87/EC to raise ambition in the aviation sector and implement the CORSIA offsetting scheme for international aviation.

Increased linear reduction factor for GHG emissions

To align the EU ETS Directive with the increased GHG emission reduction targets set in the European Climate Law, the Commission is proposing to reduce emissions from the EU ETS sectors by 61 % by 2030, compared to 2005 levels. To achieve this target, the proposal increases the linear emissions reduction factor from 2.2 % per year to 4.2 %, to be applied after entry into force of the revised directive. In addition, the emissions allowances cap would be adjusted downwards, as if the increased LRF had applied from 2021 ('rebasing'). The cap will be increased by allowances corresponding to the maritime transport emissions to be included in the EU ETS, derived from reporting under the MRV Regulation.

Free allocation

Protection against carbon leakage will still be in place through allocation of free allowances. However, the number of free allowances will gradually be reduced with a decreasing emissions cap and the proposed introduction of a carbon border adjustment mechanism (CBAM). Producers of products covered by the CBAM would receive 90 % of their free allocation in 2026, and 10 percentage points less each following year. The CBAM would gradually phase in a price on the GHG emissions linked to imports to the EU, with the overall aim of ensuring that the EU's climate targets are not undermined by less ambitious climate policies in other parts of the world.

The benchmark approach will be updated and will become more stringent to ensure a fairer and more transparent distribution of free allowances and to avoid applying the cross-sectoral correction factor. In addition, the maximum annual update rate will be increased from 1.6 % to 2.5 % from 2026. Moreover, to incentivise the adoption of low-carbon technologies, the free allocation would be reduced by 25 % for installations that fail to implement recommendations from the energy audits required by the Energy Efficiency Directive or take equivalent measures to reduce GHG emissions.

Under the current rules, an installation using innovative technologies to reduce GHG emissions may fall out of the ETS and stop receiving free allowances if it reduces the capacities of its combustion units. This would place it at a competitive disadvantage relative to an installation with emissions below the benchmark level and which thus receives more in free allocations than it emits.

The proposal would allow installations to stay in the ETS after introducing low-carbon innovations, thereby also lowering the benchmark and encouraging more emission reductions. It makes the definitions of activities technology-neutral, refers to production capacity instead of combustion capacity, and reviews the benchmark definitions to ensure technology-neutral treatment of installations.

Market stability reserve

The MSR Decision (EU) 2015/1814 would be amended to enable a smoother intake of allowances to the reserve, the closer the surplus on the market is to the specified threshold, to avoid 'threshold effects' where one extra allowance in circulation can trigger the intake. From 2023, allowances above the level of auction volumes of the previous year would be invalidated, and the number of allowances in the MSR would be limited to 400 million. The revised MSR would include the aviation and maritime sectors in calculating the total number of allowances in circulation.

The MSR would have a separate section for buildings and road transport. To address the risk of excessive price increases in the new ETS for buildings and road transport, additional allowances from the MSR would be released in cases of sudden and significant price increases.

The 'Fit for 55' package contains a separate legislative proposal to strengthen the MSR by amending the MSR Decision to maintain the currently increased annual intake rate of allowances.

Maritime emissions

The proposal would extend the EU ETS to cover CO_2 emissions from maritime transport,[2] specifically from large ships above 5 000 gross tonnage. The extension applies to all emissions from intra-EU voyages and to 50 % of emissions from extra-EU voyages and all emissions occurring when ships are at berth in an EU port. The same rules as for the other sectors would apply to maritime emissions. The extended EU ETS would cover around two thirds of maritime emissions, with the aim of incentivising energy efficiency improvements and low-carbon technologies, and of reducing the price difference between alternative and traditional maritime fuels.

Each shipping company regulated by the EU ETS would be attributed to the administering authority of a Member State. If the company is not registered in a Member State, it would be attributed to the Member State where it had the highest number of port calls in the previous 2 years.

The requirement to surrender allowances would be gradually phased in during 2023-2025 (20 % of verified emissions for 2023, 45 % for 2024, 70 % for 2025, and 100 % from 2026 onwards). Besides the general EU ETS rules on penalties, ships could be denied entry to a port if the shipping company has failed to surrender sufficient allowances for two or more consecutive reporting periods. The Commission would have to monitor implementation of the rules, report on the adoption of a market-based measure by the IMO and propose amendments to the ETS Directive, if necessary.

The MRV Regulation (EU) 2015/757 would be amended with respect to reporting of aggregated emissions data at company level and monitoring plans for ships under the scope of the regulation.

A study on the aviation and maritime sectors and the EU ETS for the TRAN committee recommends aligning compliance cycles with the MRV Regulation, effective and flag-neutral enforcement, and use of revenues for energy transition in the maritime sector, also for shipping companies not registered in the EU. It warns of the potential shifting of maritime transport to avoid EU ports and the impact on EU trans-shipment ports.

Fuel distribution for road transport and buildings

A separate, self-standing emissions trading system (ETS II) for fuel distribution for road transport and buildings would be established, starting from 2025. Because the GHGs are emitted by small entities like households and car drivers, the regulated activity will be 'release for consumption' and the regulated entities will be fuel distributors for whom a monitoring and reporting system already exists under the excise duty system of Council Directive (EU) 2020/262.

The regulated entities would need to hold a GHG emissions permit and report the amount of fuels placed on the market, starting from 2024. From 2026, they would have to surrender a corresponding amount of allowances, based on the carbon intensity of the fuels. The cap on emissions would be set in 2026, based on data from the Effort-sharing Regulation. It would gradually decrease, to achieve a 43 % reduction in emissions in 2030 compared to 2005 levels for these sectors, with a corresponding linear reduction factor. All allowances would be auctioned and none would be provided for free. Some allowances would be front-loaded to allow for a smooth start to the system.

The Commission has presented a proposal for a social climate fund, which would use 25 % of the revenues from the new ETS for road transport and buildings. This would alleviate the social impacts of passing on the carbon costs to households, micro-enterprises and transport users.

The road transport and buildings sectors would still be included in the Effort-sharing Regulation, so that national policies would continue to play a role in decarbonising these sectors. The Commission would have to report on the effectiveness, administration and practical application of the system by 1 January 2028, and propose amendments where appropriate.

Innovation Fund and Modernisation Fund

Under the proposal, the Innovation Fund would be increased by 50 million allowances (stemming from the allowances available for free allocation and for auctioning), and by 150 million allowances stemming from the new emissions trading system for road transport and buildings. Furthermore, allowances that would otherwise be distributed for free to sectors covered by the CBAM would be auctioned and added to the Innovation Fund. The scope of the fund will be extended to support projects through competitive tendering mechanisms such as carbon contracts for differences.

The Modernisation Fund would be increased by auctioning an additional 2.5 % of allowances. The additional volume would be used to support the energy transition of Member States with GDP per capita below 65 % of the EU average in 2016-2018, which would help to decrease further the low-carbon innovation investment gap and to address distributional effects. At least 80 % of the funding would have to be used for priority investments listed in the proposal; the fund would not support investments in energy generation facilities that use fossil fuels.

Use of ETS revenues

Under the proposal, Member States would be required to use all the auction revenues, unless attributed to the EU budget,[3] for climate and energy-related purposes, including decarbonisation in the road transport and buildings sectors. Furthermore, Member States may use part of the revenues for financial support to low-income households in the worst performing buildings.

Carbon capture and utilisation

Under the proposal, the obligation to surrender allowances would not arise for GHG emissions that are permanently chemically bound in a product, and thus not released into the atmosphere under normal use. The Commission would adopt implementing acts to specify the requirements.

Advisory committees

The European Economic and Social Committee (EESC) adopted an opinion (rapporteur: Stefan Back, Employers – Group I, Sweden) on the proposal on 8 December 2021, welcoming the overall ambition of the proposal but warning of possible impacts on EU industry, shipping companies and consumers. The EESC made critical remarks about the proposed ETS for road transport and buildings (ETS II), and noted that the extension to road transport had been decided against the sceptical views of the private sector, trade unions and NGOs.

The European Committee of the Regions adopted an opinion entitled 'Making ETS and CBAM work for EU cities and regions' (rapporteur: Peter Kurz, PES, Germany) on 28 April 2022. It calls for direct management of 20 % of the ETS auction revenues by local and regional authorities, and for the Modernisation Fund to be open to NUTS 3 regions in Member States with clear internal imbalances. It highlights that ETS II revenues should directly support the new social climate fund, with 35 % of these funds directly managed by local and regional authorities.

National parliaments

Two national parliaments submitted reasoned opinions before the subsidiarity deadline of 8 November 2021.

The Irish Houses of the Oireachtas consider that the proposal, along with others in the 'Fit for 55' package, is in breach of the principles of proportionality and subsidiarity, and question whether EU-level action is necessary, given that the proposal lacks sufficient quantitative and qualitative indicators to allow national parliaments to fully assess the implications. The reasoned opinion points out that the Irish Climate Action and Low Carbon Development (Amendment) Bill 2021 sets similarly ambitious targets for climate neutrality by 2050, and that Ireland intends to implement climate measures through the reallocation of revenue from a carbon tax that includes the road transport and buildings sectors.

The Czech Senate considers that the proposal breaches the subsidiarity principle because the Commission has not delivered impact assessments in relation to individual Member States, their households and their economic sectors, thus preventing national parliaments from fully assessing all the implications and the possible added value of action at EU level compared to measures taken at Member State level. It is concerned about negative economic and social impacts, especially in lower-income Member States, and expresses particular concern about the proposed separate emissions trading system for road transport and buildings. Moreover, it states that the impact assessment at EU level is based on unrealistic estimates of the development of carbon prices.

Stakeholder views[4]

The revision of the EU ETS, as well as other legislative proposals in the 'Fit for 55' package, received mixed reactions from stakeholders. Many welcomed the increased ambitions while questioning the continued allocation of free allowances and expressing concern about the distributional impacts of the proposed separate ETS for transport and buildings.

Business Europe supports the central role of the EU ETS, recalls the importance of protection against carbon leakage, and calls for additional support for investments in breakthrough technologies for decarbonisation. They welcome the fact that transport and buildings are addressed in a separate ETS, while calling for reinvestment of the revenues into low-carbon solutions. Eurelectric, representing the electricity industry, generally welcomes the proposal and calls for lowering the MSR thresholds and accelerating the reform of benchmarks.

BEUC, the European consumer organisation, considers the separate ETS for transport and buildings to be a 'high-risk, low-reward measure', warning of its negative financial impact, especially on lower-income consumers. Moreover, it would not support the uptake of energy-efficient solutions and would distract policymakers from more effective sector-specific regulation.

Climate Action Network (CAN) Europe calls for higher ambition and advocates a 70 % emission reduction in the EU ETS sectors, compared to 2005 levels, to achieve an economy-wide 65 % emission reduction below 1990 levels. CAN Europe criticises the continued allocation of free allowances, and expresses concern about the social impact of the new ETS for transport and buildings on vulnerable consumers. The Institute for European Environmental Policy welcomed the extension of the EU ETS to cover over two thirds of emissions and called for ending the allocation of free allowances by 2030 and using ETS revenues to support lower-income households and climate-vulnerable countries.

Bellona's climate scoreboard rates the overall ambition as fit for the 2050 climate neutrality target. However, they consider the decrease in the free allocation of allowances to be insufficient and point out that the actual proportion of free allowances in the system would increase from 2021. Bellona welcomes the extension of the Innovation Fund, although they consider the amount available for industry to be insufficient to support the required rapid innovative and transformative change. Finally, Bellona calls for including waste incineration in the ETS.

E3G calls for earlier phasing out of free allocation and recommends strict climate conditionality criteria for the Modernisation and Innovation Funds. Access to the latter for central and eastern European countries should be facilitated through technical assistance for funding applications, as western European countries dominated the first call for proposals.

Distributional impacts were highlighted in a report by CEPS, which stressed the contrast between the immediate carbon cost increases for citizens and the continued free allocation of allowances to industry. Similar concerns were raised by Friends of the Earth Europe, who warned that including transport and buildings would lead to high energy prices, with unequal social impacts. Bruegel also argued that the most vulnerable may be most affected by the transport and buildings ETS, despite the establishment of the social climate fund.

Legislative process

In the European Parliament, the proposal was referred to the Committee on Environment, Public Health and Food Safety (ENVI); Peter Liese (EPP, Germany) was appointed as rapporteur. The Committee on Industry, Research and Energy (ITRE) was an associated committee.

The rapporteur presented his draft report on 14 January 2022. It would include waste incineration in the ETS from 2028, would apply the ETS II to all fuels from 2025, and raise the ambition on maritime transport emissions.

On 17 May 2022, the ENVI committee adopted its report on the proposal by 62 votes to 20, with 5 abstentions. The report was rejected in the June I 2022 plenary session and referred back to the ENVI committee, together with the related proposal on CBAM. Parliament adopted the report with amendments during the June II 2022 plenary with 439 votes in favour, 157 against and 32 abstentions, and also adopted positions on the CBAM and social climate fund proposals.

The adopted text would raise the ambition to reduce emissions in the ETS sectors by further one-off cuts to the EU-wide quantity of allowances, and lower thresholds for the market stability reserve, together with an increase in the annual linear reduction factor to 4.4 % in 2024 and 2025, rising to 4.5 % from 2026 and to 4.6 % from 2029. These increases would reduce emissions in the ETS sectors by 63 % below 2005 levels by 2030, compared to 61 % in the Commission proposal. Municipal waste incineration would be included in the ETS from 2026. A bonus-malus system would incentivise best performers and innovation. The ambition for the maritime transport sector would be raised to cover 100 % of emissions from intra-European voyages as of 2024 and 50 % of emissions from extra-European voyages from and to EU ports from 2024 until the end of 2026, and extending it to 100 % of the emissions of extra-EU voyages and to ships of 400 gross tonnes and above from 2027. A new Ocean Fund, funded with 75 % of the revenue from auctioning maritime allowances and voluntary contributions of shipping companies, would support the transition to an energy efficient and climate resilient EU maritime sector. The free allowances in the ETS sectors covered by the CBAM would be phased out between 2027 and 2032. The ETS II for road transport and buildings would be established on 1 January 2024, and allowances would be auctioned from 2025 – one year earlier than proposed by the Commission. However, before 2029 it would only apply to commercial buildings and commercial road transport. To stabilise prices in the ETS II, 10 million allowances should be released from the market stability reserve whenever the average price of ETS II allowances exceeds €50 before 1 January 2030. Revenues from the auctioning of 150 million ETS II allowances would be made available for the Social Climate Fund to support social climate measures. Only regulated entities with EU ETS compliance obligations would be able to hold ETS allowances.

The Council's general approach, adopted on 29 June 2022, maintains the overall ambition proposed by the Commission. Member States that are heavily dependent on maritime transport would receive an additional share of the ETS auction revenue. Auctioning of ETS II allowances would start in 2027 and surrender obligations in 2028, a year later than proposed by the Commission. The Modernisation Fund would be open to more Member States, and be allowed to continue financing natural gas projects as a transitional measure under certain conditions. Certain provisions of the Innovation Fund would be modified, with particular attention to decarbonising the maritime sector.

On 18 May 2022, as part of the REPowerEU initiative, the Commission presented a legislative proposal that amends the EU ETS Directive to auction €20 billion worth of allowances and make the auction revenue available to the Recovery and Resilience Facility. A trilogue agreement was reached on 14 December 2022 and approved during the February II 2023 plenary session.

On 18 December 2022, the Council and the European Parliament reached a provisional political agreement on the ETS, MSR[5] and social climate fund proposals.

Ambition and scope

The agreed text increases the overall emissions reductions by 2030 in the sectors covered by the EU ETS to 62 % below 2005 levels, by setting the linear reduction factor to 4.3 % per year from 2024 to 2027, and to 4.4 % from 2028; and reducing of the overall emissions ceiling by 90 million allowances in 2024 and by 27 million allowances in 2026.[6] In case of excessive price fluctuations as defined in the directive, 75 million allowances will be automatically released from the MSR to the market. The Commission and the European Securities and Markets Authority are tasked with monitoring the functioning, integrity and transparency of the European carbon market.

By 31 July 2026, the Commission must assess the feasibility of including municipal waste incineration in the ETS with a view to including it from 2028, and report on the accounting of negative emissions and their coverage by emissions trading, accompanied by a legislative proposal if appropriate.

Maritime transport

The ETS will cover maritime transport emissions, starting in 2024 with an obligation for shipping companies to surrender allowances for 40 % for verified CO_2 emissions, rising to 70 % for 2025 and 100 % from 2026. Offshore ships of 5 000 gross tonnage and above will be included in the revised MRV regulation from 2025 and in the ETS from 2027. Non-CO_2 emissions (methane and nitrous oxide) will be included in the revised MRV regulation from 2024 and in the EU ETS from 2026. General cargo ships and offshore ships between 400 and 5 000 gross tonnage will be included in the MRV regulation from 2025 and the Commission must report on their possible inclusion in the EU ETS by the end of 2026. Derogations from ETS requirements are possible until end of 2030 for ice class ships and journeys to small islands, outermost regions or relating to public service obligations. Member States with more than 15 shipping companies per million inhabitants will receive 3.5 % of the additional quantity of allowances due to the increase in the cap for maritime transport.

Free allocation and carbon leakage

Installations that fail to comply with conditionality requirements regarding energy audits, energy management systems and climate neutrality plans, will have their free allocations reduced by 20 %. Half of the allowances that are not allocated as a consequence of conditionality will be transferred to Member States for auctioning, to address any residual risk of carbon leakage. Free allowances for the sectors covered by the Carbon Border Adjustment Mechanism (CBAM) will be phased out over a nine-year period between 2026 and 2034, at a slower rate in the beginning of this period and at a faster rate towards the end.[7] The Commission must assess the impact of the CBAM on the risk of carbon leakage by January 2028 and every two years thereafter.

Innovation Fund and Modernisation Fund

The Innovation Fund will pay particular attention to the decarbonisation of the maritime sector and the sectors covered by the CBAM. The amount of allowances for financing the Innovation Fund will be increased, and these will be frontloaded to ensure adequate resources for innovation.

As proposed by the Commission, the volume of the Modernisation Fund will be increased through auctioning of an additional 2.5 % of the cap, and three additional Member States (Greece, Portugal and Slovenia) will be eligible for funding. Fossil-fuel based energy generation will generally not be eligible for funding, with transitional exemptions for natural gas projects under certain conditions.

ETS II for buildings, road transport and other sectors

The new EU ETS for buildings and road transport fuels will start in 2027 (or 2028, in case of exceptionally high energy prices). Its scope is widened to fuels used in certain industrial sectors. The emissions reduction trajectory and the linear reduction factor is set at 5.1 % from 2024 and 5.38 % from 2028. To ensure a smooth start for the system, an additional 30 % will be added to the auction volume for the first year (frontloading). If the price of allowances exceeds €45 for two consecutive months, 20 million additional allowances will be released from the MSR to the market. Fuel suppliers must report on ETS costs passed to consumers. Where fuel suppliers are subject to a national carbon tax at least as high as the ETS II allowance price, Member States may exempt them until December 2030 and cancel the corresponding volume of allowances.

The file was split into two parts, with the monitoring, reporting and verification of maritime GHG emissions treated separately. The Parliament adopted the texts on 18 April 2023 and the Council on 25 April. The final acts were signed on 10 May 2023 and published in the Official Journal on 16 May 2023. The legal acts enter into force on 5 June 2023.

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The aviation and maritime sectors and the EU-ETS System: challenges and impacts, Policy Department for Structural and Cohesion Policies, European Parliament, October 2021.

Vettorazzi S. with Medeiros De Faria A. P., 'Fit for 55': Revision of the EU Emissions Trading System, EPRS, European Parliament, January 2022.

Marcu, A. et al., EU ETS Review: Political agreement after trilogues, ERCST, January 2023.

2030 climate target plan: extension of European Emission Trading System (ETS) to transport emissions, ENVI workshop proceedings, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, June 2021.

OTHER SOURCES

Revision of the EU Emissions Trading System, Legislative Observatory (OEIL), European Parliament.

Monitoring, reporting and verification of carbon dioxide emissions from maritime transport: inclusion of maritime transport activities in the EU ETS and of other greenhouse gases than CO2, Legislative Observatory (OEIL), European Parliament.

ENDNOTES

1. The gases covered by the EU ETS are carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF_6).
2. The FuelEU Maritime proposal, also part of the 'Fit for 55' package, addresses GHG emissions by the maritime sector by limiting the carbon intensity of the energy used on board ships, in order to support the uptake of sustainable fuels.
3. On 22 December 2021, the Commission presented a legislative proposal for a Council Decision amending the system of own resources of the European Union by adding new sources of revenue, including the EU ETS and the CBAM.
4. This section aims to provide a flavour of the debate and not to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'European Parliament supporting analysis'.
5. The amendment of the MSR Decision (EU) 2015/1814 will maintain the current doubled intake rate (24 %) and minimum number of allowances placed in the reserve (200 million) until 31 December 2030.
6. An increase in the total amount of allowances in the ETS will accommodate its extension to maritime transport.
7. The following reduction of free allocation will apply: 97.5 % in 2026, 95 % in 2027, 90 % in 2028, 77.5 % in 2029, 51.5 % in 2030, 39 % in 2031, 26.5 % in 2032, 14 % in 2033 and 0 % from 2034. The CBAM will apply only to the proportion of emissions that does not benefit from free allowances under the EU ETS.

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