

IETA Feedback: Amendment of the EU Emissions Trading System

This document provides feedback from the International Emissions Trading Association (IETA) to the European Commission's public consultation on an Amendment to the EU Emission Trading System Directive 2003/87/EC. We welcome the opportunity to provide feedback on this important topic.

The changes envisaged by this consultation constitute some of the most major reforms to the EU ETS since its inception in 2005. IETA firmly believes that decisive steps are required to align the EU ETS with the revised 2030 GHG emissions reduction target, and the broader 2050 Climate Neutrality objective. As the EU's principal decarbonisation instrument, the EU ETS must play a leading role in reaching the target of climate neutrality. The EU ETS has proven its effectiveness as an instrument in setting a binding carbon budget and steering the development of emissions and must now be further enhanced to meet the EU's ambitious targets. Such enhancements can only be achieved through alignment and consistency between the EU ETS and other key EU climate policies (such as renewable energy and energy efficiency). To necessitate this decarbonisation trajectory, changes will be needed to the structure of the ETS; the Cap will have to be tightened, LRF adjusted, new sectors placed under a cap, and serious consideration given to how the EU ETS can prepare to deliver Net-Zero emissions with a balance between sources and sinks.

Aligning the EU ETS with 2030 Target

The ETS cap needs to be adjusted in accordance with the increased 2030 target as soon as possible in order to give predictability to the ETS, provide a necessary signal for low-carbon investments and GHG mitigation generally, and minimise cumulative emissions in the atmosphere.

The LRF will also have to be adjusted as early as possible in order to meet a steeper decarbonisation trajectory, taking into account that the longer the LRF is left unmodified, the more rapid the decarbonisation required. The question of the exact LRF percentage increase is critical, as even small changes have the capacity to result in very different emissions reductions pathways. There is no single route to climate neutrality; IETA would welcome analysis from the European Commission to forecast different LRF scenarios to ensure discussion over which scenario is the most cost-effective while representing a fair balance toward reaching the 2030 target. A clear long-term framework for the Linear Reduction Factor contributes to the system's predictability and functioning of the market in the most efficient way.

In reflecting on policy adjustments required to meet the 2030 target, IETA encourages the European Commission to view the LRF as the primary tool for giving ETS actors long term visibility and clarity on decarbonization pathways. The LRF provides regulatory certainty, and allows industry to plan investments accordingly.

Should re-basing be required, IETA believes that this can be achieved through the combination of an increased LRF with a modest rebasing of the cap. However, rebasing should not be a one-off event, and IETA urges policymakers to consider staggering this over several years. A large one-off rebasing risks a discontinuity to the efficient functioning of the EU ETS, increasing the threat of price spikes, and negatively affecting criteria linked to the LRF (such as how the MSR is adjusting, and the distribution of allowances).

IETA has strongly supported the MSR during both policy development and implementation phases. The MSR, together with the rule-based automatic cancellation of excessive surplus allowances from 2023, has played a significant role in EUA price increases since 2018 and has ensured the resilience of the EU ETS during the COVID-19 pandemic.

Ensuring a strong MSR mechanism is critical to preventing any new oversupply of ETS allowances and weakening of the decarbonisation signal. Changes will likely have to be made to align the MSR with the revised 2030 emissions reductions targets and parameters. These changes must recognize that the MSR functions as a tool for market stability to manage supply/demand issues, whereas it is the LRF's role to strengthen price signal.

According to current provisions in the EU ETS directive, the intake rate of the MSR is set to reduce from 24% to 12% after 2023. IETA wishes to highlight that the European Commission should strongly consider if a reduction in the intake rate as planned has the capacity to weaken the market's ability to handle future disruption and run the risk of lower prices at times. IETA does not wish to pre-judge which value should be placed on MSR intake. Such a change should not be considered in isolation, but rather through the lens of other EU ETS changes required to align the system with the 2030 target.

In addition, the MSR's two activation thresholds (400 & 833 M EUAs) may also need to be adjusted. To what extent the MSR thresholds need to be revised in order to reflect an increasingly decarbonised economy and different hedging needs, should also be a part of the European Commission's work. Revising the MSR thresholds may be necessary, but IETA believes that such a change should only take place when there are clear reasons for doing so. Adjustments to the MSR's parameters should not be decided on before changes to other ETS policies such as market expansion, LRF, and free allocation, are finalized. This will ensure that the parameters are fit for purpose, and fully adapted to the revised EU ETS structure.

IETA also notes that the European Commission may wish to consider adjustments to the MSR invalidation mechanism. Surplus allowances in the MSR are accrued both due to rapid decarbonisation (for example, due to technological change or more efficient production processes) and the results of lower than expected industrial output from economic downturns. Currently, the MSR does not differentiate allowances based on the reason such a surplus has occurred. IETA encourages the European Commission to study whether differentiating between different forms of surplus is feasible. If the European Green Deal is to be a green growth strategy, developing a clear and transparent methodology for differentiating surplus allowances would allow allowances from the MSR which have occurred due to economic downturns to be kept aside to fulfill the requirements of European industry and to avoid cross sectoral correction factors.

Market Expansion

IETA strongly believes that in reviewing the scope of the EU ETS, the European Commission should ensure a full level playing field between all sectors in the EU. Currently, the EU ETS covers about 40% of the EU GHG emissions, but this share is expected to decrease to 35% by 2030.

An extension of the ETS in the longer term to new sectors would increase the economic efficiency of emissions reductions and would help the EU to achieve its climate objectives. Moving further emissions under a cap would provide a clear roadmap for future decarbonisation. Where the marginal cost of abatement is substantially different in comparison to sectors currently covered by the EU ETS (such as Road Transport and Buildings), a short- to medium-term solution is to create separate standalone ETS systems for these sectors. Any stand-alone sectoral ETS must be transparently designed to ensure that there is a clear cap and sufficient liquidity (an issue that IETA would be glad to make additional recommendations on), as a non-liquid market does not provide adequate price signals for decarbonisation. This design should echo the EU ETS in terms of basic infrastructure and MRV rules to ensure that longer-term inclusion into the EU ETS is technically possible, but other mechanisms can be tailored to the specific requirements of that sector. Whilst emissions trading is a powerful mechanism for encouraging decarbonisation, creating new standalone ETS systems should also be accompanied by complimentary sector specific policies to enhance the ETS price signal and tackle the non-economic barriers to decarbonisation in these sectors.

Any standalone sectoral ETS would be a stepping stone designed to create a strong price signal for sectors that would otherwise not receive one through EU ETS inclusion. This would prevent negative interference with the current ETS, and ensure that these sectors can pursue a similar learning curve to that faced by sectors included in the early phases of the EU ETS. Very little data currently exists about the emissions of these new sectors or abatement possibilities, and a standalone ETS structure will allow time for these data to be quantified and studied.

But in the longer term, IETA believes the European Commission should aim to slowly integrate these sectors into the EU ETS. This should only occur once the parallel system has shown the same efficiency as the EU ETS in terms of operation and environmental outcome. Full inclusion is only possible once the risks of shocks to the EU ETS is diminished through similar marginal abatement costs in EU ETS sectors as those in a standalone ETS. Bringing pricing levels together over time will be necessary, and could be achieved through considering flexibilities with the EU ETS.

The issue of Maritime sector inclusion is more complex, precisely because of the international nature of this industry. IETA's view is that the EU should also encourage the IMO to find a comprehensive global solution to the climate challenge. However, given that no international climate scheme for maritime currently exists, IETA supports placing full-scope shipping in the EU ETS (as long as rigorous MRV requirements are met). To ensure consistency with current ETS rules, which require that the installation is liable, the ship's operator should be liable for compliance under the EU ETS.

The effect of expanding the EU ETS into new sectors will be to reduce the coverage of the non-traded sectors. To avoid double coverage of GHG emissions, this must be accompanied by a transparent

adjustment of effort between the EU cap and ESR targets. The ESR target must therefore be removed for sectors included in the EU ETS. This is the right approach; sectors included in the EU ETS are subject to a legally binding target that will ensure they meet the challenge of climate neutrality by 2050.

IETA also wishes to note that in reviewing the scope of emissions trading, the European Commission should ensure that double coverage does not occur in relation to substituting fossil fuels by non-fossil fuels such as non-recyclable waste-derived fuels. Today, the use of these fuels are covered under the EU ETS for industrial sectors, whilst not being covered for energy production and waste management sectors. This creates a competitive distortion and requires harmonisation in the context of the EU ETS review. One possible solution would be to move activities from sectors such as waste management from the ESR to the EU ETS.

Carbon Leakage

IETA recognises that carbon leakage measures no longer reflect the current situation, nor the future scenarios envisaged by the European Commission. The measures of free allowances and indirect cost are already incomplete for some sectors, and in the light of the EU's Climate Neutrality Target, carbon leakage policies will need to be updated and revised to align with this goal. Whilst the benchmarking methodology should be reevaluated periodically, IETA does not believe that a substantial revision is warranted. However, transparency around both the benchmarking data and methodology is critical. IETA encourages a two-way transparency between both private sector actors and policymakers.

IETA recently submitted a detailed response to the European Commission's consultation on the proposed Carbon Border Adjustment Mechanism. In this consultation, IETA noted that Carbon leakage is a clear threat to the EU's target of reaching climate neutrality by 2050. The imposition of a CBAM has the capacity to address carbon leakage, safeguard the competitiveness of European industry, and encourage global climate ambition. To achieve these goals and remain compliant under WTO law, the CBAM must be designed as a market-based mechanism. IETA's preferred option is the establishment of a separate pool of allowances for imports that mirror the ETS price and are regulated through ETS rules.

IETA proposes that to ensure this mechanism works as intended, there should be a trial phase for certain sectors. The same should be true for free allocation. If free allocation is to be replaced, it must be done gradually with a phase-in period to avoid the risk of shocks to the EU ETS and serious economic disruption within sectors covered by the CBAM.

Free Allocation has proved to be a strong tool for safeguarding European industry from carbon leakage, but IETA believes that the share of auctioned allowances must increase over time. Whilst this is necessary to ensure decarbonisation, free allocation can only be reduced if other sufficiently protective policy measures have been both implemented and proved to be successful. Implementing a CBAM could provide such a replacement mechanism for some sectors.

IETA also wishes to note that in the review of the EU ETS already underway, care should be taken that no additional pressures are applied to sectors at risk of carbon leakage (such as advancing the risk of a CSCF).

Negative Emissions & The Role of Removals Credits

One key area that IETA believes has been omitted from the EU ETS consultation questionnaire is the issue of negative emissions.

In order to transition to Net-Zero, the EU will have to consider how to net-out residual emissions from European Industry. IETA fully supports the EU's "*Clean Planet for All*" strategy which highlights the role that negative emissions will have to play in achieving climate neutrality by 2050; each of the eight possible scenarios in this document call for significant usage of carbon sinks. In order to ensure the stability of the ETS in the next thirty years, the European Commission will need to propose how verified carbon emission removals from all sectors that meet high quality standards can be introduced into the ETS.

Ensuring that carbon removals are both scalable and within a reasonable price range will require European policymakers to start work on this issue in the 2020s, and have removal mechanisms ready by the 2030s. IETA advocates a neutral approach to removal mechanisms; both technological and nature-based solutions will be required to meet the Net-Zero target.

In the short term, nature-based solutions are likely to be the most immediately available. There may be some availability domestically of land-based credits, as is evident through the establishment of pilot schemes in EU countries such as France, The Netherlands, and Spain. This is a first step to providing a strong policy signal to enact investment that will ensure credits are readily available in a sufficient timescale. IETA thus welcomes the Commission's recent announcement that it is launching work on devising an EU regulatory framework for a carbon removal certification mechanism under the Circular Economy Action Plan.

However, just EU credits are unlikely to provide sufficient liquidity for compliance in the ETS as we work toward Net-Zero GHG emissions by 2050. In the longer term, supplementing these with international credits sourced under Article 6 of the Paris Agreement can provide cost-effective solutions that also speak to other EU SDG deliverables. Article 6 provides opportunities for pilot programmes that would enable channels of supply through international cooperative approaches.