BUSINESSEUROPE

POSITION PAPER

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Ambition, innovation, protection: revision of the EU ETS

THE ISSUE AT HAND

The EU emission trading system (EU ETS), which has been set up fifteen years ago, is a cornerstone of the EU's climate policy. Emissions from installations covered by the ETS declined by about 35% between 2005 and 2019. The new revision scheduled for 2021 intervenes at a moment when the continent is deciding on a major acceleration of the climate mitigation effort. At the same time, Europe is facing fierce global competition as well as continued asymmetric climate ambitions across the G20 states. And, of course, the revision should take due account of the fact that the EU should slowly recover from the most severe health and socio-economic crisis seen since World War II (e.g., disruptive effects on production levels must not lead to negative impacts on free allocation). **Therefore, more than ever, this revision needs to strike the right balance between driving ambition, supporting innovation and ensuring competitiveness**.

BusinessEurope supports the European Green Deal and the EU's ambition to become the first climate neutral continent by 2050. To make such a radical transformation successful, policymakers must ensure that the right framework conditions are in place across the EU to promote a competitive economic environment and enable investments in low-carbon technologies. The EU ETS has a key role to play in this respect. We have consistently supported the system and firmly believe that it should remain the main driver for the European industry and the power and aviation sectors to reduce greenhouse gas emissions in a market-based and cost-effective manner while maintaining our competitiveness on a global scale. The continuation of strong carbon leakage measures for direct and indirect costs will be decisive in that regard.

This position paper puts forward a first input to the upcoming revision. It is structured in two main parts. The first one sets key principles that all together form our vision for the upcoming reform. The second part provides our initial views on envisaged design options to ensure effective implementation of the principles. We intend to update and complement our views on these design options during the process.

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OUR VISION

The overarching goal is to update the EU ETS in a way that puts the carbon market in accordance with stricter emissions reduction for 2030 while fully ensuring that industry remains competitive globally. Therefore, the revision should be guided by the following principles:

- **Ambitious climate policy**: The increased climate ambition in Europe implies an acceleration of emissions reduction. This means that investments of unprecedented dimensions will have to be realised in a comparatively short timeframe. Most sectors under the EU ETS are characterized by long-term investment cycles, making 2050 the most relevant time horizon. Therefore, reliable investment conditions must be created as soon as possible to support the successful development and deployment of low-carbon technologies. The rapid implementation of Cooperative Mechanisms (article 6 of the Paris Agreement) is also required to achieve climate neutrality by 2050. In addition, the EU ETS should be adapted to allow the development of new applications based on carbon circularity, supported by carbon capture and storage/usage (CCSU).

- **Effective carbon pricing**: An effective price signal generated through a reliable carbon market is one of the key elements to achieve the EU climate neutrality ambition. The EU ETS must remain a well-functioning and reliable market-based instrument defined by the "cap and trade" approach and based on the principle of "supply and demand". This implies that political interventions should be kept to the minimum.

- **Carbon and investment leakage**: The right balance between climate ambition and protection of industry must be found. At this stage, climate ambition by Europe's main trading partners does not go much beyond long-term "goal setting" (e.g. United States re-joining the Paris Agreement, China's 2060 climate neutrality ambition). At the same time the EU has a range of specific regulations in place, that are scheduled for revision. To prevent carbon and investment leakage until the implementation of a truly global level playing field, sectors exposed to international competition must be sufficiently protected.

- **Mix of instruments**: The EU ETS has proven an effective instrument to reduce GHG emissions. However, the ETS and carbon pricing alone cannot deliver the complete decarbonisation of our industries as it cannot address all barriers to the development and deployment of low and zero emissions solutions. Therefore, additional instruments are necessary to support industries on their way to becoming climate neutral by 2050 (e.g. improved state aid rules, support for strategic infrastructures, implementation of new technologies and R&D, etc.). Complementary EU policy actions in non-ETS sectors are also indispensable. At the same time, double carbon levies on the same sectors from both the EU and national levels must be avoided.

- **Extension of scope:** The envisaged extension to other sectors, such as maritime, road transport and buildings, is a sensitive undertaking and must be considered very carefully. In any cases, an immediate inclusion of new sectors into the existing ETS would cause disruptions that risk jeopardizing the existing carbon market. Therefore, only separate emissions trading schemes could be envisaged at the beginning, with a view of possibly merging the systems towards 2050.

- **Fair effort sharing**: So far, EU ETS sectors have contributed proportionately more to the overall EU reduction target than non-ETS sectors. For a sustainable transition, the entire European economy and society will need to contribute to deliver on the increased climate ambition. It is essential that in the future the non-ETS sectors will contribute more to the reduction of GHG emissions than in the past. The additional effort, due to increasing the 2030 target, must not lead to the current ETS sectors continuing to contribute disproportionally more than others. This is crucial also in a context where synergies between sectors will play a central role, where success on some sectors will depend on progress in others, such as in the case of sector-integration solutions.

- **ETS revenues**: The ETS revenues, whether national or European, deriving from auctioning of allowances should be equipped with mechanisms that ensures the reinvestment of increased financial resources to support industrial decarbonisation and protection of sectors competing globally. At EU level, the largest share of ETS revenues should be used for the innovation and modernisation funds to equally ensure it benefits the sectors carrying the main burden of the transformation in an inclusive manner.

OUR VIEWS ON POSSIBLE DESIGN CHANGES

Business needs stable and predictable framework to develop climate solutions. Any changes to the EU ETS should be considered carefully and in line with the principles described above. Our main views concerning effective carbon pricing, the continuous protection for EU industry as well as the use of revenues, are presented below.

Effective carbon pricing

- **Linear reduction factor (LRF):** To achieve the increased GHG emission reduction target for 2030, the LRF is likely to increase significantly, in particular if it is introduced at the beginning of the second half of Phase IV (2026). An impact assessment, including an analysis of the consequences of the LRF on the number of free allowances and on a likely cross sectorial correction factor, is needed to better understand the impact of an increased LRF and the linking of the free allocation share to the cap.

- **Rebasing the cap:** Rebasing the cap would not only impact significantly the amount of emissions allowed to be emitted, but also influence the number of free allocation available and consequently increase the likelihood to trigger the cross sectorial correction factor[1]. A rebasing mechanism that impacts the number of free allowances must be avoided.

- **Market stability reserve (MSR):** A review of the MSR is scheduled for 2021. It should be conducted in connection with the revision of the ETS directive. This review should explore options to improve the MSR functioning without undermining the cost-efficiency of the system.

- **Expansion to other sectors:** As sectors have quite different exposure, price elasticities and abatement costs and thus would price carbon quite differently, forcing a single carbon market within the next few years would cause severe

[1] See ERCST, Wegener Center, BloombergNEF and Ecoact, 2020 State of the EU ETS Report, 2020

distortions in the existing system. Therefore, one needs to start with parallel systems, with a view of possibly merging the systems towards 2050. In this context, it will also be important to evaluate the practicability of upstream emissions trading and to address emerging issues with the effort sharing regulation.

Protection of EU industry

- **Auctioning vs. free allowances:** The distribution between auctioning and free allowances is an important factor to secure sufficient free allowances for the future growth of new and most efficient installations. An increased target for 2030 must not decrease the volume of free allowances. The application of the cross sectorial correction factor needs to be avoided at all costs. Increasing the share of free allocation to the amount needed or at least introducing a higher degree of flexibility between the total amounts of auctioning and free allowances and/or recycling allowances that have been invalidated instead of cancelling them might contribute to achieve that critical goal.

- **Carbon border adjustment mechanism (CBAM):** To avoid carbon leakage in certain sectors competing globally, the Commission announced to explore policy initiatives to reduce this risk. BusinessEurope at this stage is neither for nor against the implementation of a CBAM. Should it be implemented nonetheless, BusinessEurope stressed in its recent submission to the CBAM consultation that the CBAM should be fully WTO-compatible and complement instead of replace the existing carbon leakage measures such as free allowances. Well-functioning carbon leakage protection instruments should not be irrevocably replaced by a completely new instrument that has yet to prove its effectiveness.

- **Indirect cost compensation:** Several industries face high costs due to indirect ETS costs, via electricity prices. In 2020, indirect cost compensation was in place in fifteen EU Member States. An EU-wide approach should be followed, ensuring that those Member States that do not yet have compensation schemes in place come forward with such a scheme. It is crucial that energy-intensive industries are supported effectively by the EU and their national governments, one of the ways being to further improve the EU ETS state aid guidelines.

Use of revenues

- **EU ETS revenues.** The ongoing discussions of shifting ETS revenues from being mainly a national resource to an EU resource, does not change the core challenge: making sure that ETS revenues are re-invested, in a transparent way, in the sectors covered by the system. Therefore, more support needs to be provided for companies, for example by dedicating more resources to the innovation fund and introducing new mechanisms such as “carbon contracts for difference”. The industries’ capacities to reduce emissions should guide the decisions on which industrial transformation projects should be financially supported in the EU ETS context. Using criteria developed for other purposes (e.g. EU Taxonomy Regulation) would be counterproductive.

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