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Special Report: EU ETS reforms agreed after marathon trilogue negotiations

December 2022

EU ETS reforms finally agreed as Europe opts for higher ambition

Need to know

- 2030 emissions reduction target increased to 62% vs 43% previously
  - Emissions cap will fall at a faster 4.3% rate between 2024-2027 and 4.4% between 2028-2030 vs the current rate of 2.2%
  - There will also be a two-step cap reduction with a 90Mt cut in 2024 and another 27Mt cut in 2026
- Carbon Border Adjustment Mechanism will begin in transitional form in 2023.
  - Full adoption will be phased in over the 2026-2034 period
  - No direct exemption/rebate for exporters
- Shipping inclusion finalised with an aim to also add waste incineration from 2028
- Free allocation changes will reward 'good performers' and punish 'bad performers'
  - Aviators to lose all free allocation by 2026
- REPowerEU sales will start in 2023
  - Allowances will be sold to raise €20bn to help the transition away from Russian fossil fuels

Ambition increase paves the way for higher EUA prices

Marathon trilogue negotiations covering a package of EU ETS reforms finally concluded in the early hours of Sunday morning when agreement was reached between the European Commission, European Parliament and the European Council (of member states). After more than a week of intense negotiations covering REPowerEU[1], the Market Stability Reserve (MSR), the Carbon Border Adjustment Mechanism (CBAM) and expansion of emissions trading to cover transport and heating (so-called ETS2), amongst other things, the over-arching ambition of the EU Emissions Trading Scheme (EU ETS) was increased to a 62% reduction by 2030 against 2005 levels. Whilst the ambition was increased, there was also agreement to backload some of the effort due to high inflation levels and the recession European industry is currently facing – both largely caused by high energy prices.

Parliament's lead ETS negotiator and Carbon Forward panellist, Peter Liese, said "We just found an agreement on the biggest climate law ever negotiated in the EU" whilst noting that

[1] REPowerEU is the European Commission's plan to make Europe independent from Russian fossil fuels well before 2030, in light of Russia's invasion of Ukraine.

the deal gives “more breathing space for citizens and industry in the beginning but then crunch time for decarbonisation”.

The ambition increase was the midway point between the Parliament position of 63% and the 61% put forward by the member states. It also represents a huge increase from the current 43% ambition target.

Whilst the increase in ambition will ultimately result in a lower cap and fewer allowances, the negotiations allowed for a reduction of the immediate impact by opting for a two-step cap reduction rather than the originally envisaged one-off cap rebase. This a 90Mt cap cut (via reduced auctions) will be made in 2024 to be followed by a further 27Mt cut in 2026, thereby reducing some of the immediate tightness the market would have otherwise felt. In addition, the Linear Reduction Factor (LRF), that governs the speed at which the cap declines on an annual basis, will also increase in two stages. The current rate of 2.2% will be increased to 4.3% over the 2024-2027 period and then further altered between 2028-2030 to 4.4%.

Redshaw Advisors view: the increase in ambition has long been expected but the rubber stamp further reinforces the prospect of higher prices in the years to come. The 62% reduction by 2030 is a tall order in a relatively short space of time. The reduction in allowances will ultimately lead to higher prices unless European decarbonisation efforts can front-run the expedited cap reductions. On the other side of the debate, the additional allowance sales in the coming years coming from the REPowerEU bucket will help limit the impact in the short-term as Europe grapples with an inflation and recession crisis. However, the second half of Phase IV looks increasingly tight as auction volumes fall and new sectors, such as shipping that are expected to be net short, are included in the system. Steep price rises expected.

Wider policy changes

The trilogue negotiations also covered many other areas of proposed reform. A synopsis of the key elements agreed is set out below:

Price control mechanism – Article 29A

- The price control mechanism, known as Article 29A, was loosened to try and avoid the risk of spiralling prices.
- The previous wording was vague and would only have kicked in at extreme prices (i.e. three times the two-year average).
- Under the revised rules intervention will be forthcoming should the average benchmark EUA price, for a period of six months, rise to a value more than 2.4 times the price of the preceding two years.

- If an intervention is triggered, there will now be an automatic release of 75M EUAs from the MSR into auctions over a period of 6-months.
- Whilst Article 29A may help guard against very high prices, it still leaves room for EUA prices to double from the current price. Initial calculations suggest prices would need to climb to more than €160 for a period of six months in 2023 before Article 29A would be triggered. In effect Article 29A will help reduce volatility, not high prices.

Carbon Boarder Adjustment Mechanism (CBAM)

- The CBAM will be introduced across the aluminium, iron and steel, power, cement, fertilisers and hydrogen sectors.
- Free allocation is currently used to partially protect against carbon leakage (higher electricity costs caused by carbon pricing are not automatically compensated). The introduction of a CBAM will see those sectors lose their free allocation over time.
- The CBAM will be implemented in 2023 in a transitional form (i.e. importers must monitor and report their emissions but not pay for them) with full application only beginning from 2026, albeit in a phased-in process.
- A 2026-2034 timeline was agreed to fully implement the CBAM with free allowances phased out on the same timeline. Just 2.5% of free allowances will be taken away from industrial emitters in Europe in 2026 but by 2030 that will have increased to 48.5%.
- One sticking point on CBAM implementation was the treatment of exporters. The aim had been to maintain either free allocation for exported production or to provide export rebates, however, this plan was expected to fall foul of WTO subsidy rules.
- Instead the can was kicked down the road. It was agreed that in 2025 the Commission would assess the risk of carbon leakage for exporters and, if required, present a WTO-compliant plan.
- A new fund will be created to provide financial support for exporters affected. The fund will sell 47.5M of the EUAs freed up by tighter free allocation rules.

Tighter free allocation rules

- Free allocation rules will be further tightened to ensure 'good performers' are rewarded at the expense of 'bad performers'.
- Under the new rules, companies will need to conduct energy audits to avoid losing up to 20% of their free allocation.
- In addition, the worst performers will need to set climate neutrality plans or face losing 20% of their free allocation.

- The Commission estimates that the tighter rules will free up 75Mt, 47.5Mt will go to the new fund created to guard against export carbon leakage with the remainder going into the Innovation Fund to help industry decarbonise.
- Benchmarks used to determine the number of free allowances per unit of production will also be changed with the minimum improvement rate increased to 0.3% from 0.2% per annum. Going forward, Benchmarks will be applied by product rather than process.

Municipal waste incineration inclusion

- Emissions from municipal waste incineration will need to be measured and verified from 2024 with the aim of full inclusion into the EU ETS from 2028.
- Municipal waste's inclusion is likely to see the cap increased by roughly 160Mt to accommodate the additional emissions coverage, equal to roughly 10% of the current cap.
- The move is aimed at capturing more of Europe's emissions in the flagship scheme whilst also providing additional incentives for recycling.

REPowerEU

- The contribution of the EU ETS to the REPowerEU proposal was also agreed as part of the EU ETS reform package. €20bn will be raised by the sale of allowances to part finance the overall package of €300bn.
- At a price of €80, 250M EUAs would need to be sold, equating to 83Mt per year if sold over three years.
- Funds will be used to help Europe transition to Renewable Energy at a faster rate, thereby decarbonising but also reducing reliance on the import of Russian fossil fuels.
- The exact timeline and start date for the sales are not yet confirmed but it is expected that the allowances will be sold over three years and start in Spring 2023.
- The allowances will be sourced from the Innovation Fund (60%) and front-loaded auctions (40%).
- However, the final deal also included a clause to replenish 10% of the Innovation Fund with allowances taken from the MSR.
- Whilst it is envisaged that the majority of the funds will be spent increasing the share of Renewable Energy, the deal does not preclude fossil fuel investments. However, the deal's 'do no harm' principle will likely limit fossil fuel funding.

Shipping

- The inclusion of shipping in the EU ETS was finally sealed with journeys to, from and between EU ports covered.
- Intra-EU voyages will be fully accountable for their CO2 emissions but voyages to and from Europe will be accountable for half their emissions.
- The shipping sector will have to cover emissions not only from CO_2 but also methane, nitrogen oxides and soot. Only CO_2 was included in the original Commission proposal with the other gases monitored and reported from 2024 and then included in verified emissions figures from 2026.
- The inclusion of methane will impact LNG powered vessels due to methane slip while the inclusion of nitrogen oxides will affect older vessels and the use of certain bunker fuels on EU voyages.
- A phase in period, starting in 2024, will cover just 40% maritime emissions. This will rise to 70% in 2025 and 100% in 2026.
- The initial scope (in 2024) will cover the ships that are already in the Monitoring, Reporting and Verification (MRV) system set up by the EU, which are the great majority of cargo and passenger ships with over 5,000 gross tonnage.
- The maritime sector is responsible for more than 3% of the EU's emissions and when fully covered the sector will represent about 8% of the EU ETS.
- Large offshore vessels (such as vessels that help erect wind turbines and oil rigs) that are over 5,000 tonnes deadweight are also to be included in the monitoring from 2025 and then in the ETS fully from 2027.
- General cargo vessels and offshore vessels between 400 and 5,000 gross tonnage are to be included in the MRV from 2025. In 2026 the commission will evaluate whether these vessels will be included in the EU ETS.
- 20M EUAs have also been earmarked for a fund to help the shipping sector to decarbonise.
- In 2028 the European Commission will review the coverage of the maritime sector by the EU ETS and harmonise the parameters with measures taken by the International Maritime Organisation (IMO). An international carbon pricing mechanism for the maritime industry is still being negotiated by the IMO and may be finalised during the Marine Environment Protection Committee (MEPC) meeting at MEPC 80 (their 80th such annual meeting) in 2023. Last week's MEPC 79 seemed to steer towards a Greenhouse Gas (GHG) levy under which each tonne of GHGs emitted will be priced at an agreed specified cost. All revenue will be paid into a central fund which will be used towards the decarbonisation of the sector.

- The agreement will likely take into account some derogations for ice-class ships, ferries to small island communities, voyages to the outermost regions (OMR) of the EU and ships operating under public service obligations.

Aviation

- Under the deal agreed by the trilogue, aviators will have to cover the cost of all of their emissions from intra-EU flights from 2026, the date from which they will receive no free allocation.
- The free allocation phase out will see allocations cut by 25% in 2024, 50% in 2025 and then full auctioning of allowances in 2026.
- 20Mt of free allowances will also be set aside to reward those who increase their use of Sustainable Aviation Fuels (SAF) which currently comes at a very high cost compared to jet fuel.
- Flights from Europe to the rest of the world will be added from 2028 if the EU deems the climate ambition of ICAO's CORSIA offsetting mechanism is not high enough.

ETS2

- One of the most contentious elements of the proposal was the creation of a second ETS that covers private and public road transport and building heating. As it will run in a separate, parallel ETS, it has been nicknamed ETS2.
- ETS2 will begin in 2027 and will operate alongside, but separate to, the current EU ETS with the idea to eventually combine the systems and create a uniform price. No date has been given for when that might happen.
- Due to the sensitivity around increasing costs in an inflationary environment, the ETS2 system features a one year delay mechanism should energy prices remain exceptionally high.
- In addition, a tight price control mechanism will automatically release 20M ETS2 Allowances if their price rises above €45.
- Some member states already have such systems in place for road transport and buildings, they will be free to choose to implement both or adopt only ETS2.

Market Stability Reserve (MSR)

- The MSR was introduced in 2019 to tackle the surplus allowances that had built up through Phase II and III.
- Annual calculation of the surplus governs the number of allowances removed in the following year. If the surplus is great than 833Mt, allowances are removed. If it is below 400Mt, allowances are reinjected, in between the MSR sits dormant.

The above thresholds are unchanged despite Parliament's attempts to push the upper threshold down.

- The trilogue negotiations saw no amendments to the original Commission proposal that sought to maintain a 24% withdrawal rate.
- However, an annual cancellation of allowances held in the MSR will take place with the reserve set to hold no more than 400M allowances. Whilst the cancellation does not affect supply in the short term, it does mean that the MSR will be exhausted of allowances much sooner than originally envisaged with the MSR currently holding more than 2 billion tonnes.

Funds increase

- Both the Innovation Fund (IF) and Modernisation Fund (MF) will be increased following the agreement of changes. The IF will be boosted to 575Mt versus 450Mt prior to the agreement while the MF will be increased by auctioning an additional 2.5%.

Next steps

The deal will require formal approval by the Commission, Parliament and member states. The Commission approval is likely to be a formality while Parliament is likely to vote early in the new year with enough support expected for the reforms to pass. The Council of member states requires a qualified majority but a vote in favour of the proposed package is also likely to garner enough support to pass.

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