Confidential – intended for Carbon Support Programme subscribers only. Distribution of this document is restricted by contract. Please read the important disclaimer at the end of this document.

Special Report: Further details on the EU ETS reforms emerge

March 2023

Clarity provided on the implementation of some of the EU ETS reforms

Since we sent out our December 2022 special report on the EU ETS reforms, the process to rubber stamp the reforms has progressed. Several votes have taken place to push the reforms closer to the final sign-off. This includes a vote on February 9th by the Committee on Environment where a number of amendments to the framework directives for the EU ETS were passed, providing further details on the implementation of the reforms.

We cover the additional details and their potential implications for industry in greater detail below.

Key Takeaways

General updates to the ETS framework

- Confirmation that there is no change to the Free Allocation share (43%).
  - Despite the proposed reduction of free allocation to certain sectors i.e. CBAM covered sectors, aviation and those affected by the higher benchmark reduction rate, the free allocation share of the cap will continue to be 43% (+3% buffer, if required). This provides assurance to other sectors that their free allocation won't change and reduces the risk of a potential requirement for a Cross Sectoral Correction Factor (CSCF) as the EU ETS's cap reduces. This will help alleviate some of the longer-term competition concerns.
- ETS2 (for Buildings and Road Transport) is aiming for a 2027 start date. However, there is a possibility this is delayed to 2028 if oil and gas prices remain exceptionally high.
  - Although this will not have a direct effect on the current EU-ETS, this signifies intent to tighten carbon budgets across the board.
- Product Benchmarks
  - Maximum reduction rate increased to 2.5%/yr for allocation period two (AP2) from 1.6%
  - Minimum reduction rate increased to 0.3%/yr for AP2* from 0.2%
    *The minimum of 0.3% for AP2 was included in the baseline modelling of your 1Q2023 quarterly audit
- 20% reduction in free allocation for the highest 20% of emitters in each product benchmark, to encourage decarbonisation:
  - Installations with the highest GHG emissions intensities under each product benchmark will be required to implement a strategy to decarbonise.
  - There will also be requirements for these sites to implement energy-efficiency measures identified during energy audits, provided the measures have a payback time of three years or less.
  - Failure to adhere to these rules will result in a penalty 20% reduction in free allocation
- Additional free allocation to be made available to the district heating sector:

- 30% extra free allocation available for district heating in Member States where the share of district heating emissions per GDP share exceeds a value of 5.
- Any additional free allocation is to be used entirely for financing projects that reduce emissions
- Extra allocation will be subject to set-up and implementation of a verified climate-neutrality plan

- Exemption from the application of a potential CSCF for installations whose emissions intensity falls below the average of the 10% most efficient installations within their given benchmark.
  - Extra allowances will be sourced from the 20% reduction penalty applied to installations that fail to implement mandated carbon-neutrality measures

Changes to the Compliance cycle calendar

- Confirmation of no change to the 2023 free allocation, verification or surrender deadlines
- However, the annual compliance cycle will be modified from 2024 onwards as follows;
  - Free allocation deadline will be moved back to 30th June to allow member states more administration time due to the added complexity of Phase IV's dynamic free allocation
  - Deadline for operators to surrender allowances moved from 30th April to 30th September
  - The verification deadline will remain unchanged (31st March)

So, the 2024 calendar year deadlines will be as follows[1];
- Verified emission reports for 2023 have to be submitted by the end of March 2024 (as before)
- Member states have to issue free EUAs for 2024 emissions compliance by the end of June 2024
- Installations will need to surrender EUAs covering 2023 emissions by the end of September 2024

The amended calendar should ensure that free allocations for the year ahead continue to be received before the previous years' surrender deadline, providing installations with the same level of flexibility. However, delaying the surrender deadline to the autumn switches the key 'compliance buying window' to the summer. This coincides with the half auction volumes in August, potentially creating further upward pressure in what is typically a strong month.

Changes to Annex I (new sectors to be included in the EU-ETS)

- Waste incineration

[1] Please note there is some ambiguity to the wording on the compliance cycle changes. We cannot rule out the surrender deadline for 2023 emissions remaining the end of April 2024. However, this is not our interpretation of the amendments

  - Monitoring and reporting of emissions from 2024
  - Possible inclusion in the EU ETS from 2028
- Hydrogen and syngas production processes greater than 5 t/d
- Refining of oil (not only mineral oil) in installations with a thermal capacity greater than 20MW
- Production of iron (so, not only pig iron)
- Alumina production
- Gypsum / Plaster board production – amendment of inclusion threshold from 20MW to 20 t/d
- Carbon black: - amendment of inclusion threshold from 20MW to 50 t/d

The vast majority of the Annex 1 changes will not lead to large scale changes in inclusion, they are clarifications of the existing policy in order to close potential loop-holes that could be used to avoid mandatory ETS compliance. Member states are required to bring into force the laws and administrative provisions necessary to comply with these amendments by 31st December 2023.

Some amendments to the scope focus on GHG emissions rather than installed capacity. It is believed this is to ensure installations that have reduced their installed capacity below 20MW thermal do not fall out of the ETS as otherwise these emissions would go unchecked.

The inclusion of the waste incineration for the electricity sector from 2028 will not only impact the electricity generators but also installations operating a boiler incinerating waste. In addition, the new sector is likely to be net short, providing a further draw on the available cap. If you would like to discuss further how this may impact your company and how to get ahead of these proposed changes, please reach out to your Account Manager.

Biomass

The emissions rating of biomass incineration has long been under review by the European Commission (EC). Under the Renewable Energy Directive, energy sourced from biomass needs to fulfil sustainability criteria to be zero-rated.

Currently, installations with a biomass boiler capacity above 20MW are obligated under the EU-ETS, but provided the biomass combusted is over 95% sustainable the plant's emissions are considered zero-rated. From 2026 (the second allocation period of Phase IV), the EC is looking to exclude biomass plants from the scope of the EU ETS provided that more than 95% of the emissions from the plant stem from the combustion of 'sustainable' biomass. However, this will be looking at the average emissions for the baseline period (2019 – 2023), so it is our understanding that sites which transitioned to sustainable biomass part way through the baseline period will not be excluded.

The good news for all biomass installations, is that this amendment to exclude sites that qualify, indicates that in the longer term it is unlikely that sustainable biomass will be reassigned as a non-zero-rated fuel and therefore it will continue to have no compliance costs associated with it.

Carbon Border Adjustment Mechanism (CBAM)

- Phase-in of CBAM obligation for EU imports in affected sectors will run in parallel to the phase-out of free allocation in the EU ETS
- Free allocation that is no longer given to CBAM sectors will be auctioned, with the revenues directed to the Innovation Fund, with special attention given to projects from CBAM sectors
- Member states may use ETS revenues to address any residual risks of carbon leakage in CBAM sectors
- Review of carbon leakage risk for exports from CBAM sectors one year before the end of the transitional period (2023-2026)

CBAM sectors will soon start to lose free allocation. Whilst non-EU competitors will face carbon costs to level the playing field, the EUA buying and budgeting requirements for EU producers will increase materially by the end of Phase IV and beyond. The main risk for EU based producers is the lack of free allocation/compensation for the exports. The 2025 review of this exposure will be key.

The spread of CBAM, if successful, is inevitable as the pot of free allocation dwindles as the cap falls. It is our understanding that sectors such as paper / cardboard and chemicals narrowly avoided being included in the first iteration of CBAM and will be first at risk of inclusion in subsequent reviews. Companies in these sectors should start to plan for the worst case scenario, whereby allocations start to be phased out for them also.

Redshaw Advisors' reaction

There are still more 'knowledge gaps' to be filled in on how the ETS reforms will be implemented. We expect further details to emerge through 2023.

In addition to a tighter cap and higher buying requirements across the board, interest in the EU ETS and potential demand for EUAs is likely to grow from companies outside of the EU who will be exposed to CBAM. They will be looking to hedge the price risks they are set to face, creating another source of demand. However, it is still not clear exactly how the price they pay will be calculated and whether they will be billed at the point goods enter the market or on a periodic basis.

Overall, these clarifications continue to showcase the European Commission's commitment to higher ambition. There is a clear emphasis on rewarding those who decarbonise whilst penalising those who do not. But, with the recent energy crisis across Europe and increased cost of borrowing as inflation soars, further investment in decarbonisation may be difficult for many companies in the short to medium term. These companies, more so now than ever, will need to plan carefully as short-term decarbonisation inactivity will increase risk out to 2030. Reducing emissions through efficiency improvements will need to be high on the priority list when funds are available as the compounded problem of higher market prices (EUAs recently topped €100) and penalties for the lack of decarbonisation (the loss of 20% of free allocation for the worst performers) are likely to quickly outweigh decarbonisation costs.

Breakdown of Redshaw Advisors' full services

Redshaw Advisors' Compliance Carbon Services

INFORM	ADVISE	PROCURE
Unrivalled market intelligence bringing you the latest pricing and developments for EU and UK carbon allowances. Consultancy and training on all aspects of emissions trading activities – delivered by renowned carbon market experts.	Advisory and risk management services to help you manage your carbon exposure and reduce the carbon cost to your business. Bespoke consulting advice on any aspects of global compliance markets – tailored to your needs.	With decades of carbon trading experience, our award-winning team can provide a route to market for all carbon emissions products, including: • EUAs • UKAs

Redshaw Advisors' Voluntary Carbon Market Services

INFORM	ADVISE	PROCURE
Tailored training programmes covering all aspects of the voluntary carbon market – delivered by market-leading experts. Exclusive market outlook reports – market pricing, analytics, supply and demand trends and developments	Dedicated carbon market advisory services: • Carbon market and strategy advice, footprinting guidance and confidence in communicating achievements • Leading carbon credit market insight and analysis • The latest pricing intelligence across all carbon credits	Our market specialists can assist with carbon credit procurement strategies – across all standards, platforms and contract types. A commitment to transparent pricing with our maximum margin guarantee.

Redshaw Advisors' Renewable Energy Services

INFORM	ADVISE	PROCURE
Latest renewable energy pricing for Environmental Attribute Certificates (EACs) and Power Purchase Agreements (PPAs). Custom-made training programmes on global power markets and renewable technologies – delivered by market-leading experts.	Multi-lingual advisory and unique solution services to help you achieve your renewable energy targets.	Cost-effective EAC procurement to address your Scope 1 and 2 emissions through: • GOs • REGOs • RECs • I-RECs • RGGOs • PPAs

Disclaimer

No part of this document may be copied, duplicated or redistributed without the written consent of Redshaw Advisors Limited. This document has been prepared by Redshaw Advisors Limited for informational purposes only and shall not constitute an underwriting commitment, an offer of financing, an offer to sell, or the solicitation of an offer to buy any products or securities described herein. The views and information expressed in this document do not constitute and may not be relied upon as constituting any form of investment advice, inducement to invest or recommendation in relation to transactions and /or any related products or securities described herein, and prospective investors or clients must obtain appropriate, independent professional advice before making investment decisions. The information in this document has been compiled in good faith, but no representation or warranty, express or implied, is made as to the accuracy, completeness or correctness of the information provided. Redshaw Advisors Ltd, its officers, employees, representatives and agents accept no liability whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) from the use of this document or reliance on the information or views contained herein.