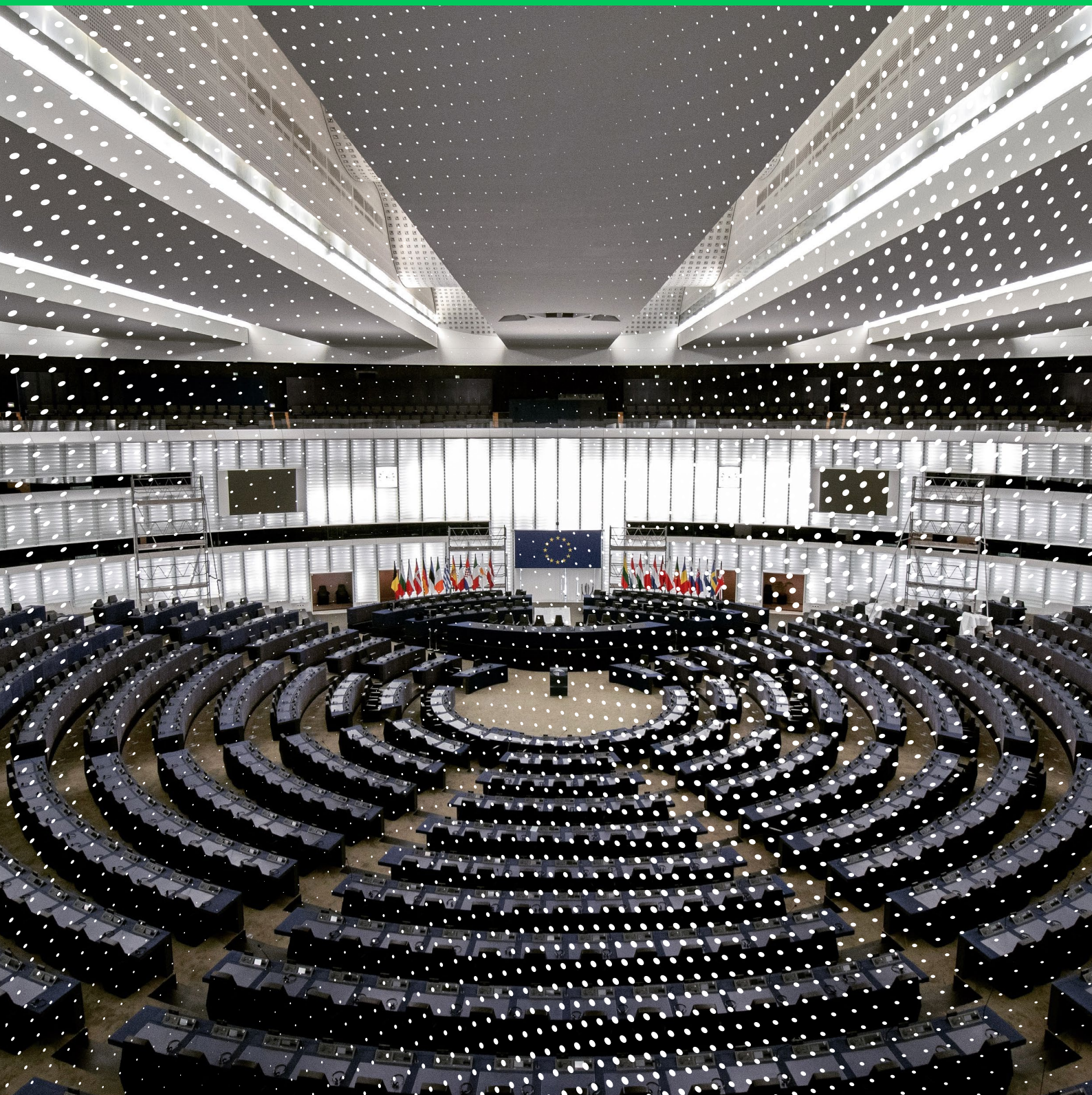
TRILOGUE TRIANGULATION

Mapping the positions of the EU institutions on carbon market reform

EMISSIONS TRADING EXTRA



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INTRODUCTION

As part of its 'Fit for 55' climate package, the European Commission proposed a comprehensive reform of the Emissions Trading System (ETS) in July 2021, including expanding the ETS to cover buildings and transportation, This was complemented with the introduction of a proposed Carbon Border Adjustment Mechanism (CBAM). In June 2022, the European Council and the European Parliament voted on their respective positions on the new files. As their positions diverge significantly, the subsequent trilogue negotiations between the three EU institutions have proven to be both tough and decisive.

To find common ground and hammer out a common position on the EU ETS, the three institutions will, starting in October, engage in a so-called 'trilogue', a process in which they discuss and negotiate the ultimate details of the overhaul.

What is on the table for the trilogue? How do the positions of the EU institutions compare?

This report provides an overview of the positions adopted by the EU institutions on the revision of the EU ETS. Thanks to a quantitative model developed by Climact, the authors were able to make a qualitative and a quantitative comparative assessment of the positions and provide sound recommendations for the final agreement based on robust numbers and scenarios.
The first section of the report explores in detail the overall positions of the EU institutions and provides general recommendations for the revision of the EU ETS at European level.

COMPARATIVE ANALYSIS OF THE POSITIONS

OF THE EU INSTITUTIONS ON THE EU ETS REFORM

Higher ambition, lower emissions

The aim of the EU ETS is to reduce emissions in a cost-effective and efficient manner. The current related directive sets a 40% target of emissions reduction to be achieved by 2030.

The launch of the European Green Deal in 2019 raised the European Union's climate ambition and required the revision of all climate-related policies, including the EU carbon market. The blueprint for this reform process came in the shape of the so-called Fit for 55 package, which aims to achieve a 55% reduction in overall EU greenhouse gas emissions by 2030. To do that, the European Commission proposed a 61% target for the highly polluting EU ETS sectors, in light of their disproportionately high emissions.

The Environment Council backed the Commission without changing any element surrounding the ambition of the EU ETS.

In contrast, the European Parliament, after months of negotiations and power struggles, managed to put its weight behind a moderately higher target. Through a faster reduction in the number of available pollution permits, the European Parliament agreed on a roughly 64% reduction in emissions for the ETS sectors by 2030.

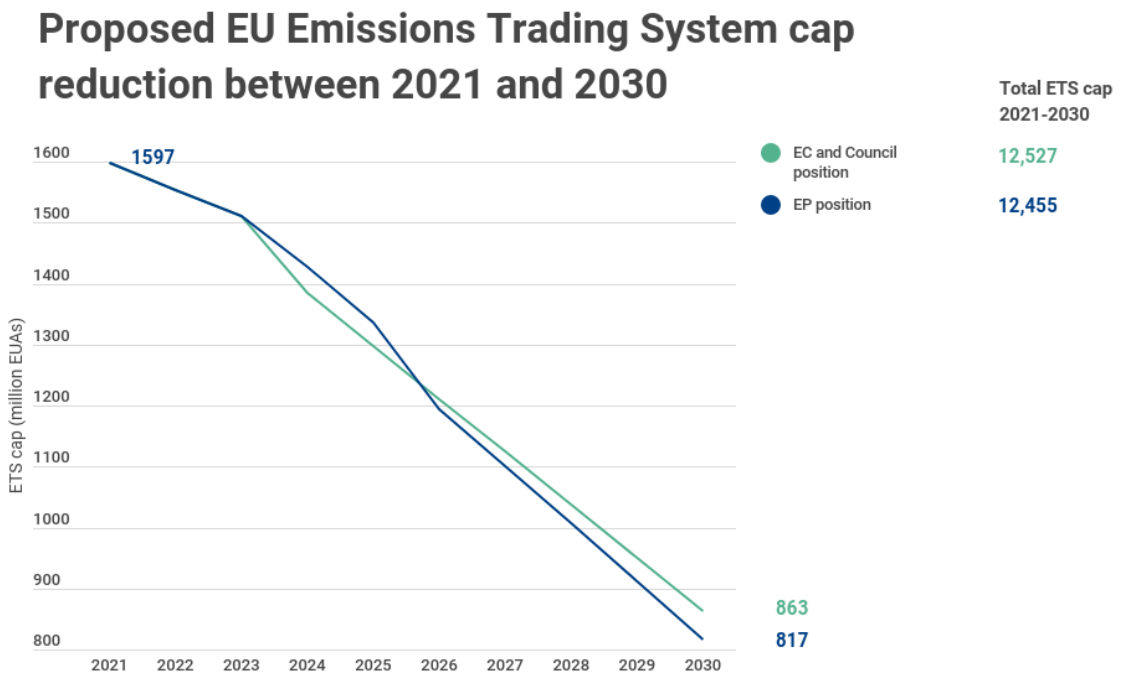

Figure 1: Proposed EU ETS cap reduction between 2021 and 2030

None of the three options being considered by the EU institutions put Europe on a path that is compatible with its commitments under the Paris Agreement and with keeping the global temperature rise below 1.5°C.

In light of what the science says is required and the recent droughts and flooding, it is paramount that highly polluting sectors, such as those covered by the EU ETS, be made to slash their emissions and to speed up the transition to cleaner and more efficient production processes.

Extending the era of freebies

Free allowances are a form of protection against the risk of carbon leakage that has been in place since the beginning of the EU ETS. However, by muting the carbon price signal for companies, these free pollution permits have also acted as a disincentive for emissions reductions, in particular when it comes to large polluting companies.

To incentivise deeper emissions reductions and reduce the risk of carbon leakage, the European Commission proposed the introduction of a Carbon Border Adjustment Mechanism (CBAM). This mechanism would price the emissions embedded in imported goods consumed in the EU. It would also (progressively) replace free allowances to EU industries, thereby exposing EU companies to the full carbon price signal and incentivising investments in reducing greenhouse gas emissions.

In its proposal, the European Commission envisaged a 10-year transition period for selected sectors to phase out free allowances during which CBAM is phased in. Over this period, the amount of free allowances allocated to these industrial sectors would steadily decrease by 10% each year to reach zero in 2035.

By reducing free allowances to cement, iron, steel, fertilisers and aluminium only by 10% every year, these industries would still receive 50% of the free allowances they currently receive in 2030. Adding these to the allowances allocated for free to all other sectors, the Commission's proposal still envisages handing out more than 4 billion allowances for free between 2021 and 2030.

In its position, the European Parliament agreed to include more sectors in the CBAM regulation and shorten the free allowances phase-out period to 2032. However, as the parliament wishes to delay the beginning of the phase-out period to 2027, this still leaves half of free allowances to CBAM sectors untouched by 2030. With the inclusion of more sectors in the CBAM, this results in overall slightly more free pollution permits between 2021 and 2030 than in the Commission's proposal.

The Environment Council adopted an even more conservative approach that prolongs the availability of free allowances to the sectors included under the CBAM. Under this scheme, these sectors will continue to receive 70% of the current free allowances in 2030. The Council also stretches the phase out of free allowances to 2036.

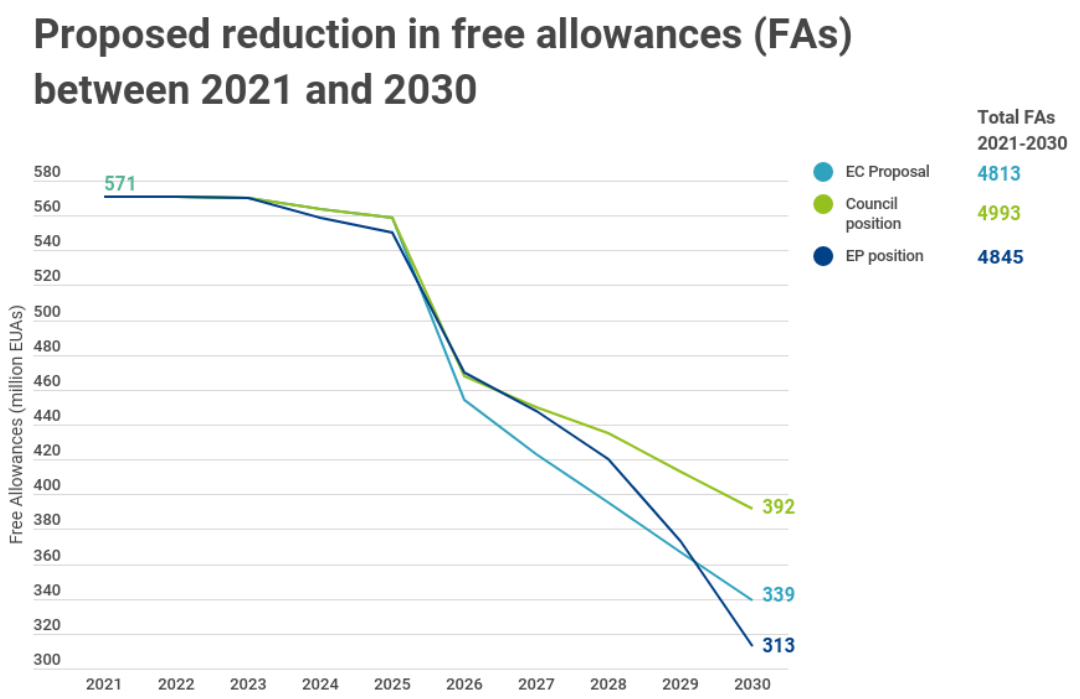

Figure 2: Proposed reduction in free allowances between 2021 and 2030

Free allowances have been detrimental to the decarbonisation of industrial sectors in the EU. Continuing this practice in addition to establishing a CBAM will fail to motivate major polluters to make the necessary emission reductions to reach climate neutrality by 2050 at the latest.

It is paramount that the final deal reached in the trilogue includes a faster implementation of the CBAM and a speedier phase out of free pollution permits, by 2032 at the latest.

Innovative solutions

The Innovation Fund was set up to finance innovative projects with a significant potential for slashing industrial emissions, as well as for renewable energy and energy storage.

To incentivise deeper and faster industrial decarbonisation, the European Commission proposed to expand the Innovation Fund by increasing the share of allowances auctioned to finance the fund from all ETS sectors and by diverting to the fund all allowances not allocated for free to sectors covered by the CBAM. This translates to a total of 899 million allowances for the Innovation Fund between 2021 and 2030.

Recognising the importance of innovation to drive industrial transformation, the European Parliament agreed to enlarge the fund, increasing the share of allowances assigned to innovation from auctioned and free allowances as well as adding an additional 0.5% of the total cap to the fund. However, by delaying the implementation of

the CBAM and slowing down the phasing out of free allowances to CBAM sectors, the Parliament's position ends up creating an Innovation Fund comparable to the Commission's proposal by 2030.

Going in completely the opposite direction, member states agreed to reduce the size of the Innovation Fund. While part of the reduction is due to a proposed redistribution of allowances to the Social Climate Fund, the largest decrease is caused by the slower phase-out of free allowances to sectors covered by the CBAM. As a result, the Innovation Fund would stand to receive only 670 million allowances between 2021 and 2030.

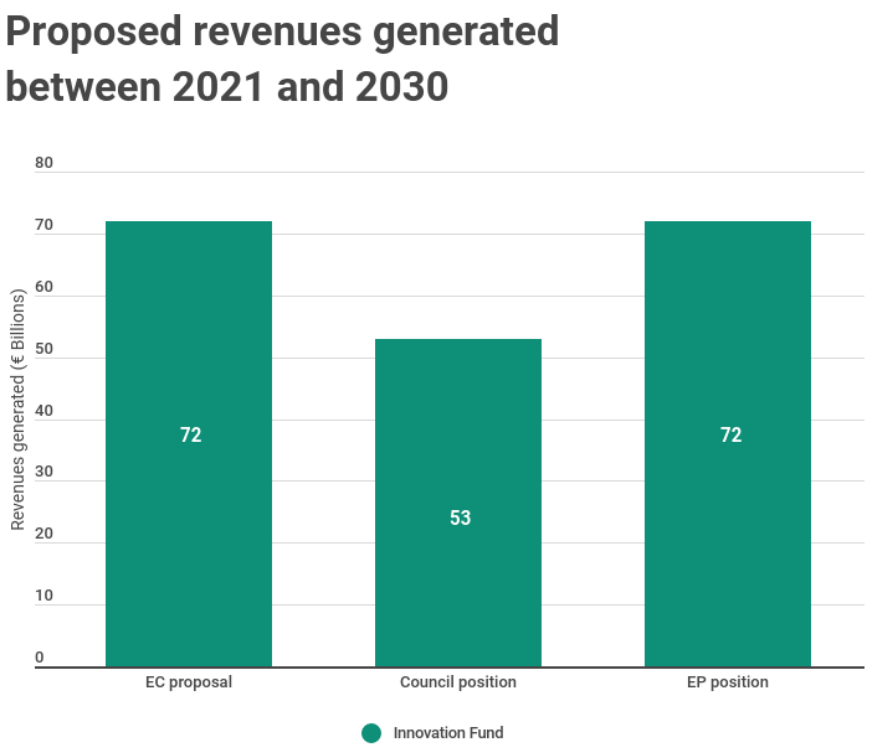

Figure 3: Proposed revenues for the Innovation Fund generated between 2021 and 2030

Leaving nobody behind

The Modernisation Fund was established to support 10 lower-income EU member states in their efforts to modernise their power sector and improve energy efficiency. Responding to the need for a faster roll out of renewable energy and higher emissions reduction targets, the European Commission proposed to increase the size of the fund and expand access to a few more member states in need of more support with the decarbonisation of their power sector. In practice, this translates into an additional 2.5% of total EU allowances to be auctioned to the Modernisation Fund and the inclusion of two more member states as beneficiaries: Greece and Portugal.

The European Parliament backed the Commission's proposal and improved the criteria for assigning funds through this mechanism to ensure the exclusion of funding to fossil fuel

projects and to increase transparency and public participation in the project selection process.

The Environment Council also agreed with the extra funds for modernisation but did not back any exclusion of fossil fuel projects nor any extra safeguards on project selection. The only change member states made to the Commission's proposal was to open access to the fund to more countries compared to the Commission's proposal.

Making polluters pay their way

By auctioning EU ETS allowances, member states raise significant revenue from the EU carbon market. This is meant to be reinvested in boosting the green transition and in contributing to achieving EU and national climate targets.

The revision of the EU ETS set out to boost the funds available to member states to invest in climate action, by both increasing revenue flows and making the spending of this revenue on climate mitigation and adaptation mandatory.

As the EU ETS relies on auctioning, reducing the volume of allowances given away for free plays an important role in bolstering the revenue generated by the EU carbon market.

As explained in the section above, by proposing a regular and steady decrease in the supply of free pollution permits starting in 2026 and by including only a handful of sectors in the CBAM, the European Commission's proposal would yield about €320 billion in auctioning revenue between 2021 and 2030 for all member states (at an assumed CO2 price of €80 per tonne).

In their general approach to the EU ETS, member states maintain the same level of revenue as proposed by the Commission by supporting the same CBAM sectors and start date, as well as by reassigning allowances from the Innovation Fund to the Social Climate Fund.

In contrast, the European Parliament's position would result in lower ETS revenues for member states. This is due to the fact that the parliament includes more sectors in the CBAM, thereby allocating more auctioning revenue to the Innovation Fund rather than member states' budgets.

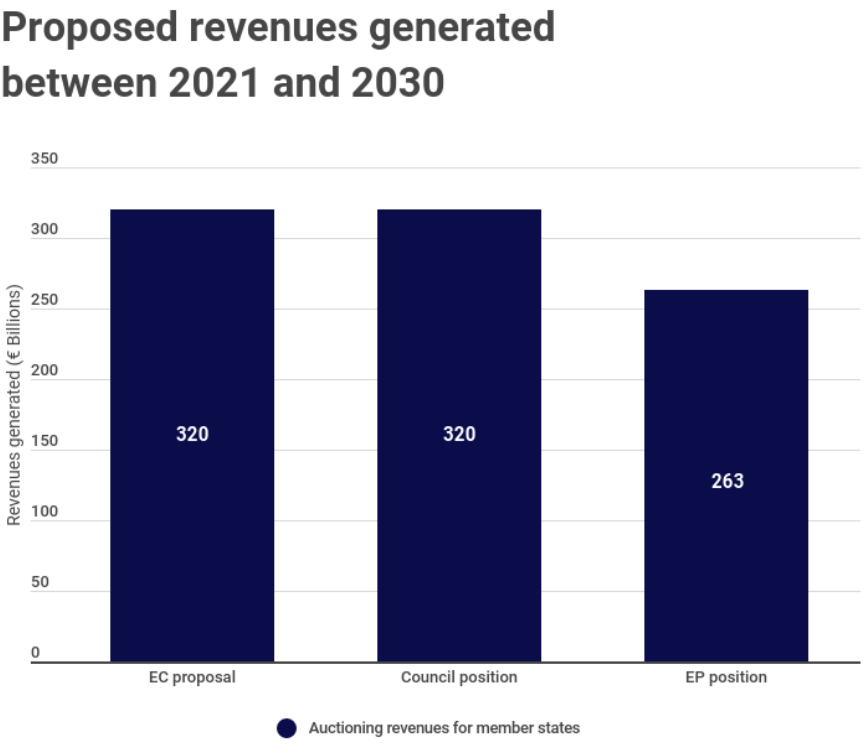

Figure 4: Proposed revenues generated for member states between 2021 and 2030

To support national climate action as well as provide more resources to EU funds dedicated to emission reduction and innovation, such as the Innovation Fund, it is crucial that free allowances be phased out as soon as possible, and at the latest before the end of this decade. This would help generate enough resources through auctioning of allowances for member states and for the Innovation Fund, providing incentives for decarbonisation and financial support both at national and European level.

MAKING THE MOST OF THE TRILOGUES: OUR RECOMMENDATIONS

After the two co-legislators adopted their positions on the revision of the Emissions Trading System, the three EU institutions will need to hammer out a joint agreement on the central elements of the EU ETS for it to become law.

A first trilogue meeting took place in July 2022 but the finalisation of the agreement is scheduled for December 2022.

It is, therefore, essential that policymakers agree the most ambitious deal possible, one that will set the EU on a path to decarbonisation and wean it off its dependence on foreign fossil fuel.

To ensure the bloc reaches climate neutrality by 2050 and fulfils its commitments under the Paris Agreement, it is crucial the three institutions agree on the following elements:

1. At least 64% emissions cuts by 2030

Co-legislators should increase the 2030 ETS emission reduction target to at least 64%, as proposed by the European Parliament. This should be achieved through a combination of a higher linear reduction factor (LRF) as well as a stronger one-off reduction of the cap, as suggested by the European Commission. The Market Stability Reserve (MSR) should also be strengthened to ensure that allowances are promptly withdrawn from the market as companies reduce their emissions.

2. CBAM in by 2026 and free pollution permits out as soon as possible

Moving away from free allocation of EU ETS allowances and replacing this system with the CBAM is the most effective way of incentivising heavy industry to reduce their emissions.

To this end, CBAM should cover all highly emitting industrial sectors, including hydrogen, organic basic chemicals and polymers, as well as indirect emissions. It should also be implemented as an alternative to existing carbon leakage protection measures as soon as possible, by cutting the share of free ETS allowances for CBAM sectors significantly from 2026 onwards, reaching 0% by 2032 at the latest.

3. Strong conditionalities to the allocation of free pollution permits

Sectors continuing to receive allowances for free should fulfil strict conditions and requirements. The allocation of free ETS allowances to industry should be made fully conditional on both energy efficiency audits and the establishment of ambitious decarbonisation plans at installation level. The worst performers should have all their allowances taken away if they fail to fulfil all the requirements.

4. Enough resources for innovation

Reducing emissions and moving to cleaner production processes and fully renewable energy sources is a crucial step to reaching climate neutrality by 2050.

It is, therefore, key to ensure that the Innovation Fund has enough resources to channel into zero-carbon and renewable energy projects as soon as possible.

The Innovation Fund should receive at least 900 million allowances between 2021 and 2030. A faster phase out of free allowances in combination with the implementation of CBAM would free up even more allowances that could be partly channelled to the fund and partly used to finance climate action in member states.

5. Strict criteria for accessing the Modernisation Fund

The Modernisation Fund is critical for supporting the modernisation and decarbonisation of the power sector in lower-income EU member states. To ensure it is effectively used, the proposed increase of resources to the fund should be maintained and access to it should be made conditional on countries having set a national target of reaching climate neutrality by 2050 at the latest.

Funding for nuclear energy and fossil fuels should be excluded, as it is completely incompatible with the aims of the fund and the overall objective of the European Green Deal.

6. 100% for climate action

The European Commission and the European Parliament are in favour of making it mandatory that 100% of ETS auctioning revenue is used for climate mitigation and adaptation. This position should be reflected in the revised directive. Moreover, it is paramount to provide better guidance and define the list of criteria and activities on which ETS revenues should be spent. While EU member states should be free to decide on what kind of climate action to spend ETS revenues, stricter criteria should be put in place to avoid the misuse of resources to finance unsustainable technologies and practices that are not in line with the goal of reaching climate neutrality by 2050.

To better track how ETS revenues are spent and to compare how member states use this income, it is important to pass the European Parliament's proposal on stricter and more transparent reporting.

THE NATIONAL PERSPECTIVE: COMPARATIVE ANALYSIS OF THE EU POSITIONS BASED ON KEY NATIONAL PRIORITIES

The three different positions the Parliament, the Council and the Commission in the the EU ETS revision would lead to different outcomes for member states in terms of overall emission reductions under the EU ETS, the volume of the allowances distributed to each country, the corresponding revenues (i.e. the member state revenues, the Modernisation Fund and the Innovation Fund) and the speed of the phase out of the allowances offered to the industrial sectors for free, along with the phase in of the new Carbon Border Adjustment Mechanism (CBAM).

In the following section we use a model built by Climact to comparatively evaluate the impact each of the three positions have on the above-mentioned parameters for five case study countries: Belgium, the Czech Republic, Germany, Greece and Poland.

Belgium

Belgium was the only country that abstained from voting on several crucial files of the 'Fit for 55' package, including the Social Climate Fund (SCF) and the Emissions Trading System for road transport and buildings (ETS 2), due to a lack of internal agreement. Since there was substantial divergence within the Belgian governments, notably between a more defensive Flemish position and a more proactive federal position, Belgium abstained.

There has been less disagreement over CBAM, which received broad support from both the Flemish and federal governments, along with a demand to support exporting sectors.

What the different scenarios mean for Belgium

For Belgium, sectoral free allocation volumes (by 2030) would be broadly similar across the three EU institutional positions, with the exception of the chemical sector, steel and to a lesser extent cement. In the chemical sector in particular, the Council and Commission would allocate over twice as many free allowances than the Parliament position. These differences emerge after 2026 and they are mainly due to the fact that the EP included the chemical sector in the CBAM regulation thus being in favour of a drastic reduction of free allowances to this sector as CBAM is phased in. In total, going by a EUA price of €70/tons, the Council scenario would allocate about €18 billion in free emission allowances (2021-2030) to Belgian firms, about €500 million more than in the EP scenario.

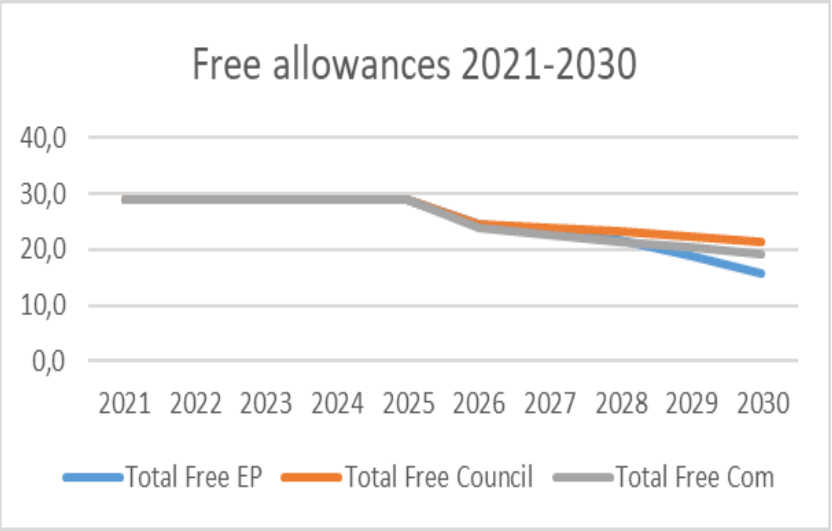

Figure 5: Proposed free allowances for Belgium from the three scenarios between 2021 and 2030

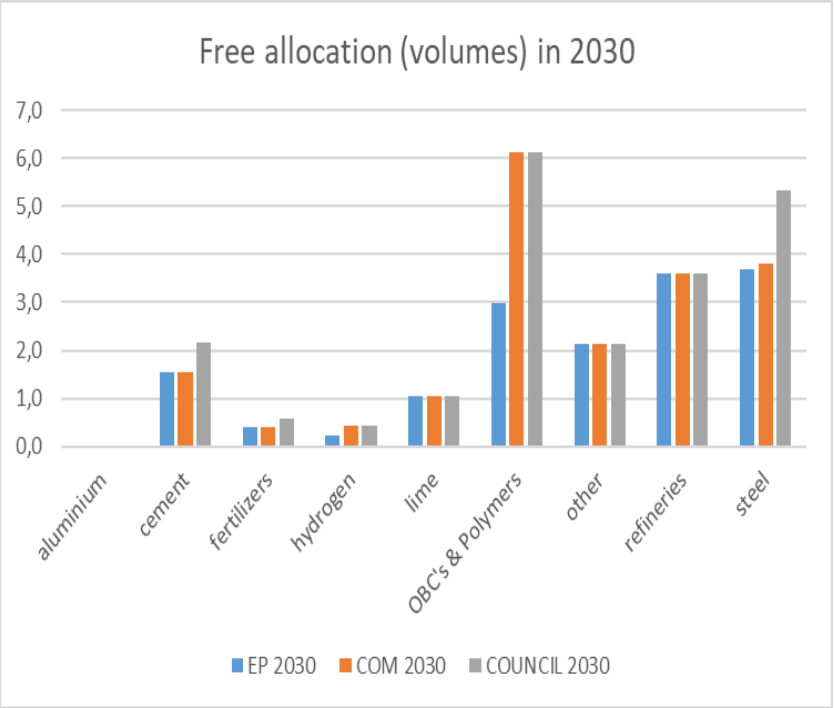

Figure 6: Proposed free allowances for Belgian industries from the three scenarios in 2030

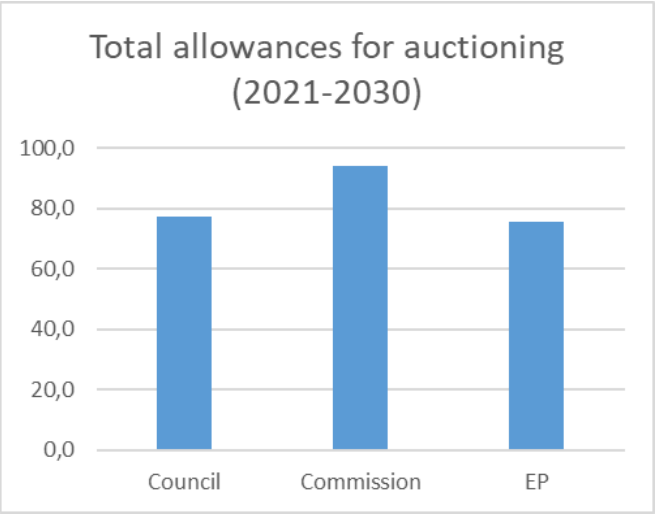

Figure 7: Proposed total allowances from the three scenarios in Belgium between 2021 and 2030

The Commission proposal leads to by far the highest auctioning volumes. With a €70 price, the Parliament scenario results in about €5.3 billion in revenues over the course of 2021-2025, while the Commission scenario accumulates about €6.5 billion.

Recommendations for Belgium

1. Support a strengthening of the ETS' carrots and sticks

Belgium should support a strengthening of the ambition levels in the EU ETS review. Domestic industrial policies have lacked strong push and pull instruments, so an increase in EU ambition, and the closely correlated increase in funding through the Innovation Fund, is a crucial requirement for decarbonisation in the Belgian ETS sectors.

Flanders, in particular, should abandon its efforts to drive down ambitions related to rebasing, the Market Stability Reserve (MSR) and the Linear Reduction Factor (LRF), and safeguard free allocation. Of course, additional national level targets and instruments will also remain indispensable.

The introduction of a broad CBAM is also crucial. Domestic and EU policy has been consistently paralysed by endless debates over carbon leakage. CBAM should put an end to these discussions, and the associated support mechanisms like free allowances or various other subsidies, by enjoying a speedy phase-in, coverage of all high emitting sectors, and inclusion of indirect emissions.

Following the same line of argument, the introduction of strong conditionalities for the allocation of free emission allowances should also be supported by Belgium. Flanders has already been introducing similar parameters in other support instruments, and a link with the ETS conditionality would provide coherence across instruments, level the playing field

with other EU firms, and strengthen the incentive set out by this conditionality, which is currently quite weak.

In terms of the trilogue options, this means supporting a mix of the Parliament's and the Commission's proposals:

- a broadening of the scope of CBAM without a delayed introduction (and thus phaseout of free allocation);
- a strengthening of the innovation fund by allocating more allowances;
- a 64% target combining rebasing, a steep enough LRF and a strengthened MSR.

2. Use of revenues

Whatever the outcome of the trilogue, the revenues from ETS auctioning will balloon in the coming years as prices rise and free allowances are phased down. One priority in this regard will be further reform of domestic use of indirect carbon leakage subsidies, financed through ETS revenues. Projected expenses on this defensive and overly generous subsidy, are set to increase in the coming years. The recent reform of its modalities was a step forward, but, among others, the Netherlands has gone further in imposing clear conditionality, and in limiting the eligibility for support. Flanders should anticipate the introduction of CBAM, and either remove this support mechanism or thoroughly reshape it into a tool for climate-oriented investments rather than compensatory operational support.

3. ETS 2 and SCF

On the contentious broadening of the ETS to road transport and buildings, Belgium should support the creation of a European price instrument. Domestic efforts to install carbon pricing have consistently faltered, and have been confronted by internal institutional complexities. Research by the federal government has shown that a progressive use of ETS 2 revenues can correct regressive effects, and provide much needed funds to increase investments that provide environmental as well as social benefits.

To safeguard the social and ecological use of these funds (within Belgium but also within the EU) and public support for ETS 2, the SCF should be considered a fundamental piece of the puzzle. Intra-Belgian discussions over the distribution of the (anticipated) income from the new ETS should start as soon as possible.

Czech Republic

With EU ETS not falling very high on the national political agenda of the Czech government, mainly due to the ongoing energy crisis, the Czech Republic has been taking a reserved approach to the current reform. This was also partly due to their supposedly neutral position originating from its presiding over the Council and the need to steer the discussion towards successful trilogue talks. However, during the French Presidency, it was made clear that the Czech Republic is not an avid supporter of the sectorial extension

of the system. Regarding the overall ambition, the agreed one-off reduction and the increase of the LRF, Czechia is in line with the Council's general approach.

What the different scenarios mean for the Czech Republic

Modernisation fund and auctioning revenues

Due to the strong industrial representation, among the main priorities of the Czech Republic is the transformation of the industrial sector that is closely connected to the phase out of free allowances, the Modernisation fund as well as the sectorial extension of the EU ETS to the buildings and the transport sectors (ETS 2).

While the position of the Council offers the most generous allocation of free allowances to the EU Member States, the proportion of the Modernisation fund that the Czech Republic could benefit from is almost the same in all of the three proposed scenarios, varying between 222.5 million EUAs (proposed by the Council) and 223.1 million EUAs (proposed by the Commission).

Czechia has largely used the opportunity to increase their share from the Modernisation fund, receiving around 193 million of the available 643 million EUAs. However, in the scenario proposed by the Parliament, Czechia would benefit less from auctioning revenues (23.1 million EUAs between 2021 and 2030), while the Commission and Council's positions would allocate 51.8 million EUAs. This could represent up to €2.3 billion with an average price of 80 EUR per emission allowance.

As important energy efficiency programmes are funded from auctioning revenues in Czechia, such as the successful 'New Green Savings' programme, a recommendation for the Czech government would be to defend the position of the Council and that of the Commission on national allocations.

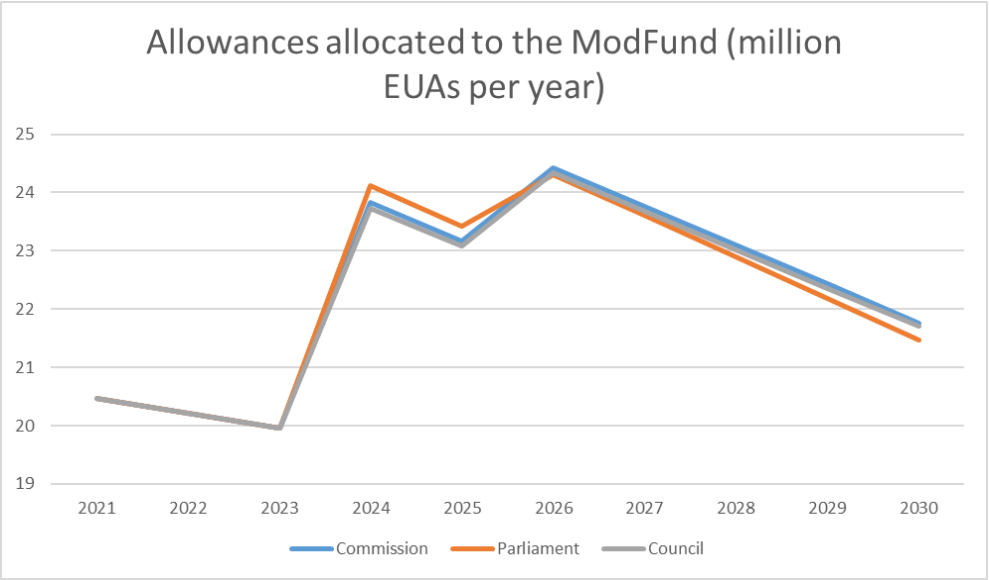

Figure 8: Proposed allowances allocated from the Modernisation Fund to the Czech Republic from the three scenarios between 2021 and 2030

CBAM

CBAM has been considered one of the main priorities and was advocated by the Czechs "in order to set a level playing field in relation to entities from third countries in terms of carbon leakage". The general concern is that the CBAM would adversely impact the automotive and steel industries in the Czech Republic, among others, and decrease the competitiveness of its industrial sector as a result. Lastly, Czechia also advocates for a more centralised form of the CBAM – meaning that the registry of importers would be created on the EU level, and not by member states.

The Social Climate Fund and the EU ETS 2

The Social Climate Fund has been one of the priorities of the Czech Republic's environment and industry and trade ministries. Czechia is looking for the SCF to be available as soon as possible which is why it might support the Parliament's position for the fund to be used as early as 2024. However, it would probably not challenge the already agreed position of the Council to establish the fund over the period between 2027 and 2032 to coincide with the entry into force of the ETS 2. In this case, Czechia needs to defend the position of the Council, while paradoxically, being more inclined to the proposition of the Parliament.

Regarding the volume, Czechia should stand behind the Council position so as to secure a larger part of the SCF due to additional auctions for the Social and Climate Fund available in the Council's general approach.

The Czech Republic also supported an exemption for non-private actors from the ETS 2 and also supported a delayed start of the auctioning and surrender obligations compared to the Commission proposal.

Germany

Germany differs from many other member states in several respects. First, having a large industrial sector geared towards the global market, the economy relies on exports. Second, Germany has a climate protection law with a 2045 climate neutrality goal, which means the country intends to follow a more rapid decarbonisation path than the EU on average. Moreover, Germany currently has a centre-left governing coalition in which the Green party, among others, holds the Ministry of Economy and Climate. With the Greens holding key ministries, ambitious climate policy, including a rapid coal phase out and development of renewable energies, has become a priority for the government.

Third, Germany already has a carbon price for transport and heating, along with plans on how to use the respective revenues, which started in January 2021 with a fixed price of €25 per tonne of carbon dioxide equivalent. The price is set to rise each year until the fixed price is replaced by a price corridor of €55 to €65 in 2026. The government plans to use the revenues to finance, among other things, a payment to all households known as a climate dividend. Since the very beginning, Germany has been in favour of a European system of pricing emissions from road transport and buildings and the national ETS was designed in view of a future transition to a European system.

Against this backdrop, key priorities for the German government and many other German stakeholders concerning the ETS reform include the overall ambition of the existing ETS, the transition from free pollution permits to the CBAM, the use of CBAM revenue, and the proposed ETS for buildings and road transportation.

Varying ambitions

Since civil society, based on what is required by science, demands an emissions cut of over 70% from ETS sectors; agreeing on a reduction of at least 63% should, therefore, be the trilogue's outcome. The German government, in particular, should support this higher reduction target.

First, in light of its high historic per-capita emissions, Germany has a particularly high responsibility to slash its emissions. Second, given its significant expertise in engineering and the large number of German companies producing technical equipment, Germany is well positioned to benefit commercially from this high climate ambition by, for instance, exporting zero-emission technologies, setting standards, etc. Third, as Germany has a national 2045 climate neutrality goal, the country is required to substantially speed up its national energy and industry transformation and so should also support an EU-wide acceleration.

From free allowances to CBAM

Given the importance of its industrial sector, a key priority for Germany is the prevention of alleged carbon leakage. This requires an effective transition from the allocation of free pollution permits to a full auctioning of emission allowances backed by a functioning CBAM, which would impose a carbon price on polluting imports.

The Council position to phase in the CBAM very slowly was strongly influenced by pressure from the German government. As it stands, the CBAM would only cover imports and not exports. Given the importance of exports in Germany, German industry is reluctant to commit to a more ambitious schedule. The government, too, believes there is a risk that companies would not be shielded from competitive disadvantages in the scenario in which free allocation is phased out and the CBAM only covers imports. Against this backdrop, Germany is not willing to agree to a fast phase down of free allocation.

According to the German government, this problem could only be solved by addressing the exporting sectors, at least to some degree. Suggested alternative approaches include the establishment of an International Climate Club or the granting export rebates, but both involve significant obstacles and risks. Other approaches such as Carbon Contracts for Difference (CCfDs) or a more generous Innovation Fund can be part of the solution but might not be sufficient to convince the German government to change its stance.

These instruments are vital if free allowances are to be reduced at a higher rate, which is key for several reasons. First, industry within the EU needs the full price signal as an incentive to invest in the required deep transformation. Second, a swift introduction of the CBAM is necessary as an incentive for trading partners to invest in the decarbonisation of their energy and industrial sectors. Third, phasing out free allocation substantially increases revenues for member states, as explored in the next section.

As shown in figure 9 of the three proposals, there are slight variations in the volume of allowances that Germany would be able to allocate. Overall, for the period of 2021-2030, Germany would receive 1,074.3 million pollution permits under the Commission's proposal, 1,089.2 million under the Parliament's proposal, and 1,118.5 million as proposed by the Council. At a price of €80 per tonne and assuming all allowances are sold and none are given away for free, this would mean revenue, between 2021 and 2030, of just under €86 billion under the Commission's proposal, just over €87 billion under the European Parliament's proposal, and €89.5 billion under the Council's proposal.

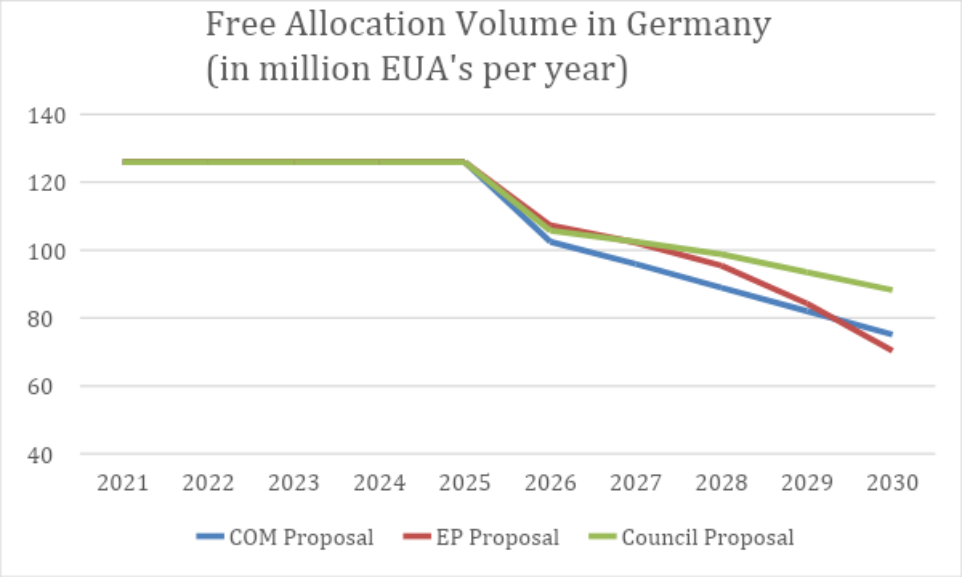

Figure 9: Proposed free allowances received by Germany from the three scenarios between 2021 and 2030

ETS revenues

The different proposals by Commission, Council and Parliament also have significant implications for the amount of auction revenue and the available finance for both EU and national funds.

In any case, the vast majority of auctioning revenues will continue to be at the disposal of member states. Therefore, it is crucial that EU countries are obliged to use 100% of revenues for climate-related purposes.

In Germany, this is already the case: 100% of ETS revenues go to the German Energy and Climate Fund which finances diverse programmes, such as renewable energy, industrial transformation, climate-friendly transport and energy efficient buildings.

Over the 2021-2030 period, Germany is set to have an overall auctioning volume of 943.8 million allowances under both the Commission's and the Council's proposals. However, although the overall auctioning volumes are the same in both proposals, we can discern a crucial difference as regards the additional auctioning revenues, based on the respectively proposed reduction of free allocations. In the Council proposal, the amount of additionally auctioned allowances would only be 54 million. In contrast, the Commission's proposal would yield an additional 98.3 million allowances (source: own calculation based on the

Climact model). If we assume a carbon price of €80 per tonne, the difference would amount to over €3.5 billion in additional revenue. Under the European Parliament's proposal, Germany would have an overall auctioning volume of 783.5 million allowances over that same period.

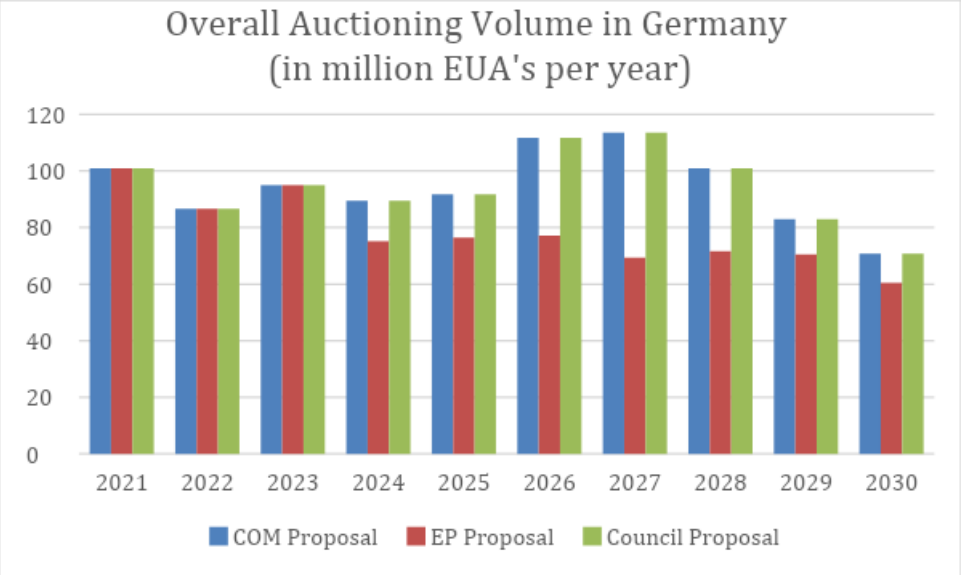

Figure 10: Overall autioning volumes in Germany from the three scenarios between 2021 and 2030

CBAM revenues

A very broad and diverse stakeholder alliance in Germany is supporting a more constructive and climate-just use of revenues, i.e., not using revenues for the EU budget. Social NGOs, environmental NGOs and even industry associations in Germany are in favour of using the revenues to support the decarbonisation of industry. Unfortunately, the German government does not seem to be listening to these voices. As the amount of revenues is not substantial in the grander scheme of things while the symbolic signal to trading partners is huge, Germany and the other member states should make use of this low-hanging fruit and support the Parliament's position.

Expanding the ETS

Amongst the main priorities, if not the main priority, of the German government is the introduction of an ETS for road transportation and buildings (ETS 2). In January 2021, Germany introduced its national carbon pricing system covering emissions from heat and road transportation. The price, having started at €25 per tonne of emissions, is set to rise by a fixed amount each year. The German government aims to expand the carbon price to the whole EU by means of the proposed ETS 2, as it considers carbon pricing to be a key instrument and is in favour of as much flexibility as possible.

Within the EU, Germany is among the principal proponents of an ETS2 and the major driving force behind the introduction of this new instrument. However, at the same time, parts of the governing coalition, especially the Chancellery and the Finance Ministry, are

opposed to a comprehensive SCF. Hence, it was after pressure from the German government that the Council proposed to reduce the SCF's size from €72 billion to €59 billion. The German government continues to be reluctant to agree to more solidarity in the form of redistribution of revenues. Their argument is that Germany cannot afford this solidarity because the country is in need of the (full) carbon pricing revenues itself.

A well-financed, comprehensive and targeted SCF is indispensable, not only to prevent social hardship but also to foster acceptance of ambitious climate measures in the eastern and southern member states. Germany should concede to more solidarity, in order to both ensure social cohesion within the EU and secure support for an effective ETS 2 from the Parliament.

Recommendations for the German government

1. Higher ambition

Germany should support the European Parliament's more ambitious 2030 target of reducing emissions associated with the ETS by at least 63%. This requires an accelerated reduction of the ETS's cap on emissions. The Market Stability Reserve (MSR), in which surplus allowances are stored, should also be strengthened to prevent the market from becoming overly liquid.

2. Phasing out freebies

Germany should support a rapid transition from free allocation to a full auctioning backed by a functioning CBAM. In concrete terms, this involves an annual reduction of 10% of free allocations in the 2020s, accompanied by the corresponding phase in of CBAM, and very high reduction rates from thereon to eliminate free allocations by 2032. This would incentivise a rapid industrial transformation and generate revenues for targeted investments in Germany's industries, both through the country's own revenues and through the Innovation Fund. In addition, the German government should support the European Parliament's position of pledging at least the amount of the CBAM revenues to support so-called least developed countries in their decarbonisation efforts.

3. ETS2 and Social Climate Fund

The ETS2 should, to be effective, apply both to private and commercial emissions and commence in 2026. An increasing price cap for the first years, or, ideally, a price corridor, would protect households from price hikes. In order to secure support from the Parliament and enhance social acceptability, the German government should urgently give up its blocking position on the Social Climate Fund. The government should support a comprehensive SCF that reflects cross-border and cross-class solidarity. In concrete terms, this means that payments from the fund should already start in 2024. The size of the Social Climate Fund should increase with the ETS2 price, which can be ensured by pledging at least 25% of the ETS2 revenues to the SCF. Furthermore, the SCF should be co-financed both through a contribution by each member state and through auctioning revenues from the existing ETS.

Greece

National revenues

The auctioning volume that will be distributed to Greece (Graph 2) if the positions of the Commission and the Council are adopted (around 172 million EUAs from 2021 until 2030), is higher than the corresponding volume resulting from the Parliament's position (145 million EUAs). However, Greece's resulting revenue may be higher if the Parliament's position prevails, since the carbon price may rise to higher levels due to the higher overall climate ambition and stricter MSR embedded in the Parliament's position.

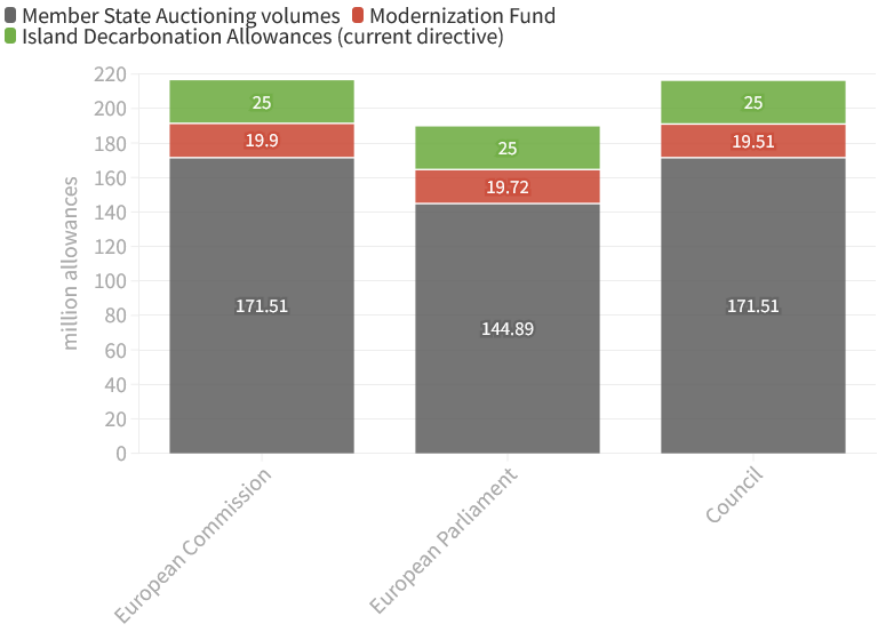

Figure 11: Greece's EU ETS auctioning volumes for the period 2021-2030 for the positions of each of the three EU Institutions as estimated by the CLIMACT ETS model

The Modernisation Fund

Regarding the extension of the Modernisation Fund for which Greece is eligible, very small differences exist between the three positions in terms of the volume of allowances Greece will receive. Using a conservative estimate of €80 per tonne for the average carbon price during the 2024-2030 period, and also adding the 25 million allowances Greece is set to receive for the decarbonisation of its islands under the current EU ETS Directive, the EU ETS will provide Greece with approximately €3.6 billion to modernise its energy sector. Graph 2 shows the sum of the member state auctioning volumes together with the Modernisation fund and the 25 million allowances for the decarbonisation of the islands.

Despite the similarities between the three positions regarding Greece's share of the Modernisation Fund, there is a fundamental difference on the type of investments that are eligible for funding. Specifically, the Commission and the Parliament completely

exclude investments on energy-related infrastructure using all fossil fuels. On the contrary, the Council's position allows investments in fossil gas, thus directly undermining the overall climate goal of the EU, as well as the REPowerEU plan to tackle the energy price crisis.

Overall, the total number of allowances that will be distributed to Greece in the period 2021-2030 is 216.4 million according to the Commission's proposal, 216 million according to the Council's position, and 189.6 million according to the Parliament's position.

Free emission allowances

There are also considerable differences in the number of free emission allowances distributed to Greece's industrial sectors according to the different positions of the three institutions. As shown in Graph 4, the Council's position would result in the highest volumes of free emissions allowances for industry (92.5 million allowances for the period 2021-2030), followed by the corresponding volumes resulting from the Parliament's position (91.2 million) and the Commision's position (88.9 million). Thus, the Council's position most undermines the efforts to decarbonise the industrial sectors, which has had only a minimal contribution to the emission cuts achieved in Greece by all EU ETS sectors during the first three EU ETS phases.

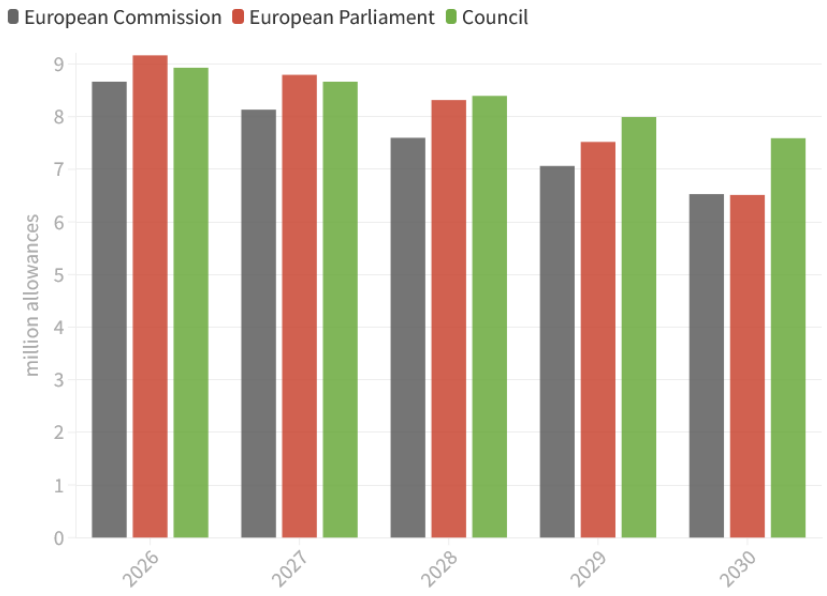

Figure 12: Free emission allowances to Greek industries for each of the positions of the three EU Institutions as estimated by the Climact ETS model

Recommendations

Based on this analysis, we propose that Greece supports the following positions in the trilogue negotiations:

1. Higher climate ambition and a stronger MSR

Greece should support a higher ambition level than that of the Council's and the Commission's preliminary positions of at least 64% emission reduction by 2030 compared to 2005 levels, as well as a stronger Market Stability Reserve (MSR) leading to a tighter control of the oversupply of allowances in the carbon market. In addition to being closer to the climate commitments the EU has undertaken by signing the Paris Agreement and the leadership role it aspires to play in global climate politics, such a position will be more aligned with the REPowerEU plan which aims to decrease the dependence on fossil fuels, especially fossil gas, more rapidly. Furthermore, higher climate ambition and a stronger MSR, will most likely lead to increased carbon prices due to the reduced number of allowances in the market, which, will in turn, translate into bigger revenue for Greece from the auctioning of the allowances that it will receive during the rest of the 4th EU ETS phase, as well as from the Modernisation and Innovation Funds.

2. Faster phase out of free emission allowances to industry in conjunction with a larger Innovation Fund

Greece should support a faster reduction rate of the emission allowances that are offered for free in the industrial sectors until 2030 and a complete phase-out by 2032 at the latest. At the same time Greece should support a larger Innovation Fund for the decarbonization of its industry. This will contribute the most in the long term competitiveness of the Greek industry, and will reduce its carbon footprint which has remained almost stagnant over the years. Moreover, incentivizing the investments necessary to decarbonize the Greek industry and increasing the available funds for this purpose, will provide a realistic chance for Greece to achieve its ambitious 2030 national climate target set in the first National Climate Law (-55% in net GHG reductions by 2030 compared to 1990 levels).

3. Fossil fuel-free ETS-related funds

Funding fossil gas infrastructure through the Modernisation Fund or leaving the door open to do the same with the national revenue from the auctioning of ETS allowances, goes fundamentally against the very scope of the EU ETS, the overall climate targets the EU has committed to, as well as the objective of the REPowerEU plan to tackle the energy crisis. Therefore, Greece should support the full exclusion of all fossil fuels investments (including fossil gas) via the Modernisation Fund, as well as dedicating 100% of the revenue from the auctioned emission allowances to climate action in line with the proposal of the European Parliament, thus contributing to a faster and cheaper transition towards carbon neutrality.

Poland

As one of the biggest beneficiaries of the EU ETS system, Poland is rather reluctant to its revision proposed by the Fit for 55 package. In particular, it opposes expanding the system with the additional sectors and flow of the income directly to the EU budget. Protection from energy poverty is one of the main concepts present in the existing political discourse in Poland. However, such doubts would be mitigated with resources of the Climate Action Social Fund. New funds would be designed to ensure subsidies for the Member States to support investments aiming to improve energy efficiency, clear energy production and sustainable transportation.

Poland's position on ETS shows that rather than achieving climate neutrality as soon as possible, the main priority is to decrease electricity prices. The solution proposed by the Ministry of Climate is to introduce price limits on the short-term markets, so that the cost of energy in the wholesale market is lower. In addition, the government proposes to introduce a fixed price of ETS allowances, or alternatively temporarily suspend the obligation to surrender allowances. It announced a temporary increase in the allocation of free allowances for certain sectors in order to mitigate the risk of bankruptcy and closure of installations, which would be in favour of suppliers of heat and electricity. The fixed ETS allowance price is proposed to be €32 and in the opinion of the Polish government should be introduced for a two-year period, with the possibility of extension. This would be a single price for all participants in the ETS.

As the Modernisation Fund is designed particularly for the needs of the member states with a worse starting point, Poland is one of its biggest beneficiaries. Money acquired from the sale of 2% of the EU ETS emission allowances for the years 2021-2030 are intended to modernise energy systems and improve energy efficiency. Even though Poland already receives the equivalent of almost 120 million allowances there will be a push to increase this share at the same time including expenditures for gas investments and waste incineration. However, it is possible that after the addition of gas and nuclear energy to the EU Taxonomy, the stance on the Modernisation Fund might relax a bit.

What different scenarios mean for Poland

Poland is one of the biggest beneficiaries of the EU ETS. The model built by Climact shows different volumes of the free allocation in million EUA's per year. The three scenarios would bring different effects starting from 2025. In the Environment Council position, Polish industry would receive the highest amount of ETS allowances for free. The Commission's and the Parliament's positions would allocate fewer free allowances and they would be similar as seen in the table below.

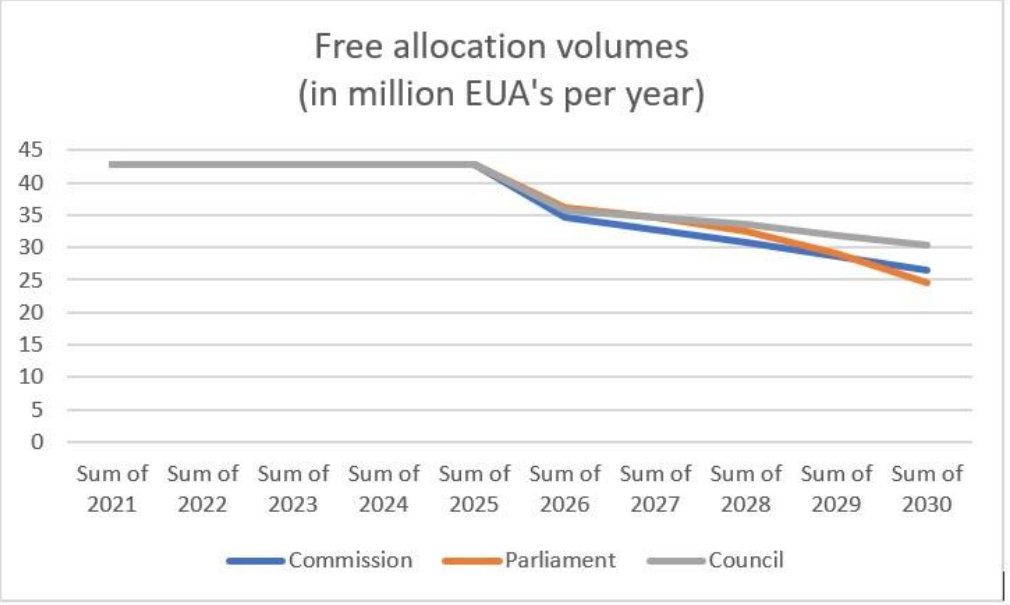

Figure 13: Proposed free allowances in Poland from the three scenarios between 2021 and 2030

In the sectoral overview of the expected free allocation volumes two seem to benefit to the largest extent, namely cement and steel. The volumes slightly differ for the three institutional actors, the Commission, Parliament and the Council, however in all three cases they remain the highest for these two sectors.

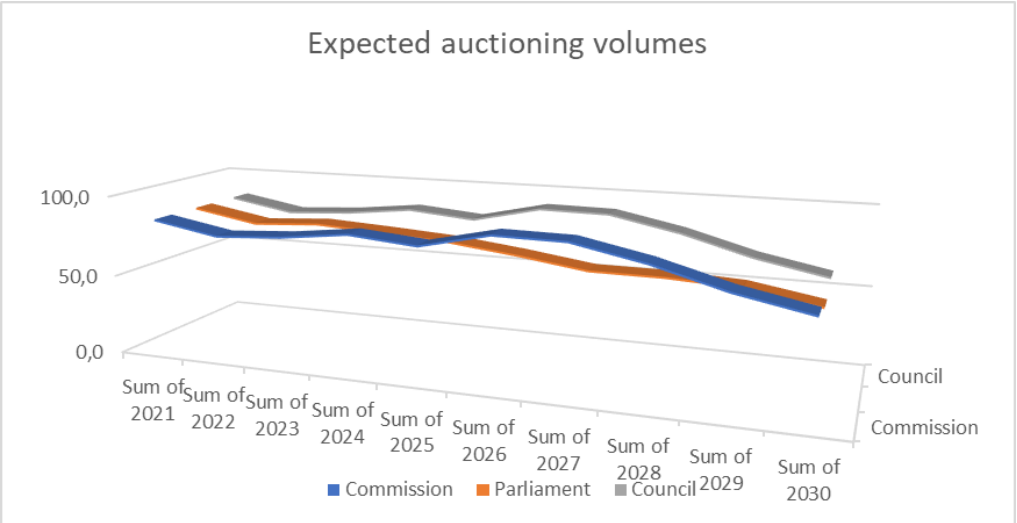

Figure 14: Proposed auctioning volumes in Poland from the three scenarios between 2021 and 2030

On the other hand, the highest auctioning volumes for Poland could be expected in case the scenario proposed by the Commission wins in the negotiations. Just slightly lower volumes would be ensured by the Council's proposition. According to the scenario, where Parliament's vision is dominant, the auctioning volumes for Poland would be much lower.

Recommendations for the Polish government

1. Higher climate ambition

Poland's climate ambitions should align with the international obligations that it undertook. As a country that has ratified the Paris Agreement it should transform its economy to make a significant contribution to meet the common goal. The European Union has a goal of achieving climate neutrality as a whole in 2050 and its package on reducing CO2 emissions by 55% in 2030 is designed in a way to help achieve it. The Polish Government announced that Poland will achieve climate neutrality in the second half of this century. As a coal-based economy, Poland definitely has a difficult starting point. However, it is high time to design a solid strategy for just transition and be more precise with the date of becoming climate-neutral.

2. Being more on-board

It is very important for Poland to show readiness for solidarity with other member states in the EU's efforts to achieve climate neutrality. The role of EU ETS and related mechanisms should be well understood, both by the Polish politicians and public opinion, so that it cannot be used as an excuse for the rising energy prices, as it is happening right now. The Polish government should show more flexibility and support for the ambitious EU initiatives rather than be a free rider as it weakens the Polish position in negotiations, apart from other negative effects.

3. Use ETS revenues according to the directive

In 2021, the Polish state budget received PLN 25.56 billion from the sale of CO2 emission allowances. According to the EU directive EU ETS, at least half of the revenue from auctions should be spent on goals related to climate protection, including the modernisation of the Polish energy sector. Unfortunately, this is not the Polish case. The climate goals are interpreted very broadly. As well as this, there is no clear strategy for the use of these funds nor transparent information on how they have been used. Only a small part of this high sum was allocated to the modernisation of the energy sector. In 2013-2020 nearly three-quarters of the funds (the equivalent of almost EUR 3 billion in 2013-2020) were used to finance activities inconsistent with the EU ETS directive (Source: ClientEarth).

CONCLUSIONS

The five case studies outlined in more detail the recommendations for a strong revision of the EU ETS and what benefits this can bring to the respective member states.

It is clear that in all instances, an ambitious reform of this key policy tool is crucial. It will lead to significant emission reductions, not only by providing a meaningful price signal to ETS sectors to invest in climate mitigation but it will also provide member states with significant revenues to fund low and zero-carbon projects in non-ETS sectors as well.

EMISSIONS TRADING EXTRA