Fit for 55 legislation: Going harder, deeper, faster with the EU Emissions Trading System

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The European Union's Emissions Trading System (ETS), the European market place for the trading of carbon emission allowances and the EU's market-based solution to climate change, already sits as the centrepiece of the EU's strategy on limiting climate change1. In June 2021, the EU adopted a European Climate Law, establishing the aim of reaching net zero greenhouse gas emissions (GHG) in the EU by 2050. The law sets an intermediate target of reducing GHG by at least 55% by 2030 compared to 1990 levels. The 'Fit for 55' package is a set of policy proposals by the European Commission to achieve this 55% reduction target. In the absence of this legislative package, EU expects to only reduce GHG by 40%. This legislative package announced in July 2021 will be the subject of intense and complicated negotiations in the EU's lawmaking institutions – the Council of the EU representing national governments and the European Parliament – well into 2022. The final content might also be influenced by the upcoming international climate change negotiations, COP 26, in Glasgow in November this year.

In this insight, we look at key aspects of the proposal.

Going harder: increasing the reduction on the GHG cap.

The cap on GHGs under the EU ETS declines by a predetermined amount each year (i.e. emissions are supposed to be cut every year). This so-called linear reduction factor (LRF) was 1.74% in phase 3 (2013-2020) and has been increased to 2.2% in phase 4 (2021-2030). The proposal is to increase the LRF to 4.2% to cut EU ETS emissions to 61% below 2005 levels by 2030, some 18 percentage points more than under the existing rules. The European Commission is also proposing a "one-off reduction" of 117m carbon emission allowances2 available for auction, to correct the trajectory of the market in the years before the tighter LRF kicks in.

Going deeper: adding more sectors to the ETS

Currently, the EU ETS only covers energy utilities, industrial emitters, and intra-EU aviation. In total, only 41% of GHGs are covered by the ETS. The Fit for 55 proposal seeks to increase coverage to the shipping, buildings, and transportation sectors. Under the proposal, emissions from maritime transport will be included in the existing EU ETS, while emissions from fuels used in road transport and building will be covered by a new, separate emissions trading system. These additional sectors are expected to become operational by 2025/2026.

Going faster: using 'modernisation' and 'innovation' funds to decarbonise quicker

The European Commission is also calling for changes to the "modernisation fund" that supports power-sector modernisation in poorer member states, using a small percentage of EU ETS auction revenues. The "innovation fund", designed to "support breakthrough innovations towards climate neutrality" with the revenues from selling 450m carbon emission allowances on the EU ETS would be boosted with another 50m allowances and 150m allowances from the buildings and transport ETS.

And the proposals don't stop there…

Combatting carbon leakage: carbon border adjustment mechanism

Carbon leakage has always been a problem for European Union. If they make the cost of operating a business in the European Union too high, internationally mobile companies would move out of the EU and export their goods back into the EU. The greenhouse gases they emit into the atmosphere would still be produced, but just outside of the EU's jurisdiction. The global nature of emissions means that the EU will still suffer from climate change resulting from these leaked emissions. One way EU has historically dealt with this issue, was to give free allocations of allowances to internationally mobile companies. Instead, it is now proposing a carbon border adjustment mechanism (CBAM) – a tax on companies bringing their goods into the EU - to level the playing field. For example, a steel manufacturer from outside of the EU would face the same cost structure when trying to sell its goods in the EU as a steel manufacturer that operates in the EU. This CBAM would mean that the European Commission no longer has to give free allocations to allowances, so as CBAM gets phased in, free allocations will get phased out. Additional revenues from CBAM can be used for innovation, modernisation, and social redistribution so that the poorest households that could face higher consumption costs (assuming companies pass costs to consumers) are not disadvantaged.

Going harder deeper and faster could be a boon for carbon prices

We have looked at a number of changes to the European Union ETS above. However, this is not an exhaustive list, and we will discuss other measures in future blogs. But what we want to highlight here is, the EU has become serious about meeting the legally binding climate goals and is seeking to put the policy tools in place to get there. Going harder, deeper and faster on the ETS illustrates that the EU wants to support more prominence in this market-based solution to climate change. We believe the tightening of allowances and expansion to more sectors (and hence greater demand for allowances) should be a recipe for higher prices for EU allowances. The December 2021 EUA futures price has already risen to €58/tonne CO2e3 from €23/tonne CO2e at the end of October 2020. If the legislation passes in full, there could be further upside.

1 Pleas see our EU Emissions Trading Systems Primer for background information

2 Allowances represent the permit to produce 1 tonne of GHG. The number of allowances issued in a given year are determined by the emissions cap.

3 Source: Bloomberg, 08/10/2021

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