Acing the revision of the EU ETS: WWF's recommendations for co- legislators

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This decade is decisive for people and nature. We have no time to lose in the race to reduce the risks of catastrophic climate change. We need bold action to keep temperature rise to 1.5°C – and we need it now.

On 14 July 2021, the European Commission put forward it's "Fit for 55% package" designed to step up EU action to decisively tackle climate change. Within the package, the proposal for an EU Emissions Trading System (ETS) aims to reduce emissions in aviation, maritime, power and industry sectors. However, the broad picture is one of weak climate action and surrender to industry lobbies. The European Parliament and Council must show resolve and fix the proposal by implementing the recommendations outlined in this paper.

Summary

Despite a couple of improvements to the legislation – such as including maritime shipping in the scope of the EU ETS and calling for all ETS revenues to be spent on climate action – the European Commission's legislative proposal for a revised EU ETS largely falls off target. WWF recommends that the European Parliament and Council implement the recommendations outlined in this paper, starting with the priority ones highlighted below:

1) **The ETS overall target should be increased to 70%** - through a combination of: linear reduction factor of 4.2% by 2023, rebasing of at least 250 million emissions by 2023 and reform of the market stability reserve (MSR) including an intake rate of 24% until 2030 and lower thresholds.

2) **Free allocation should be phased out as of 2023, and auctioned revenues should fully support industrial decarbonisation** through the Modernisation and Innovation funds.

3) **Close the fossil-fuel loopholes in the definition of 'climate action'** and condition the use of ETS revenues to projects meeting the **'do no significant harm'** test.

4) Only move forward with the extension of ETS to road transport and buildings if strong environmental and social safeguards are in place to mitigate the negative social impacts of the ETS extension to **road transport & buildings** - including through a Social Climate Fund that comes into operation at least three years before an extension of the ETS, is inclusive, adequately resourced and actively drives the decarbonisation of transport and buildings for the benefit of all groups in society.

5) **Improve accountability for how ETS revenues are spent** by generalising earmarking and scrutinising the quality of Member States' yearly reports.

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Detailed recommendations

2030 target for the EU ETS

The EU ETS emissions reduction target of 61% of covered emissions compared to 2005 proposed by the European Commission falls far short of what is required to hold global temperature increase below dangerous levels. In order to avoid overburdening other economic sectors regulated under the Effort-Sharing Regulation (ESR), it is crucial to increase the EU ETS target by strengthening further the market stability reserve (MSR) and undertaking a proper rebasing of the ETS cap. WWF calls on the co-legislators to:

- **Increase the EU ETS overall target to 70%**, through a combination of the three measures highlighted below[1].
    - **Increase the linear reduction factor (LRF) to 4.2%** by 2023, as suggested by the Commission*.
    - A **one-off reduction of the cap of at least 250 million allowances** as of 2023 in order to adjust the cap to verified emissions and avoid additional surplus. Without such rebasing, the above-mentioned LRF should be increased to 5.8%.
    - Amend the 2015 decision on the **MSR as per the Commission's proposal but with lower thresholds, put to zero until 2030**. Reforming and strengthening the MSR, in parallel to the ETS revision, is crucial in order to absorb the historical surplus (and a potential new surplus due to the COVID crisis). This can be done through a smart combination of a higher intake rate of 24% until 2030, lower thresholds, and a continuous cancellation mechanism, in order to avoid future possible shocks and market imbalances as in 2009 following the 2008 economic crisis. In its proposal, the Commission adequately covered the issues of intake rate and the cancellation mechanism, but it artificially maintains the thresholds too high - this could result in a higher surplus in 2030, which would mean the ETS target would be failed.

Ending free allocation as of 2023 and investing revenues in industrial decarbonisation

The Commission's proposal was a chance to finally apply the polluter-pays principle in the EU ETS across all economic sectors, and yet the proposed legislation extends free permits to pollute in the aviation, steel, cement and chemical sectors. The Commission's stance contradicts numerous evidence (including from the EU's own Court of Auditors[2]) pointing out

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[1] This recommendation is based on the study by Öko-Institut, "Raising the climate policy ambition of the European Union: Reforming the EU Emissions Trading", funded by WWF Germany, April 2021.
[2] European Court of Auditors, "The EU's Emissions Trading System: free allocation of allowances needed better targeting" 2018.
***These numbers (LRF, rebasing, MSR) hold as long as the market-driven German coal phase-out until 2030 is accompanied by a national cancellation of corresponding EUAs – if not, these numbers must be strengthened.**

that free allocation tends to slow the industrial decarbonisation process. Over half of all ETS permits to pollute have been given out for free since the ETS was created, and today comes a unique opportunity to change it. WWF calls on the co-legislators to:

- **End free allocation and switch to full auctioning of ETS allowances as of 2023**. Feeling a carbon price will help industry make the right investment decisions for the long-term and adapt to the new climate neutrality paradigm. Enforcing the polluter-pays principle will also see the polluter pay for emissions rather than society as a whole.
- **Invest revenues from the auctioning of free allocation in industrial decarbonisation**. The auctioning of all pollution permits will generate substantial revenues (i.e. EUR 54 billion were foregone to free allocation between 2013 and 2019). Transferring these revenues into the Modernisation and Innovation Funds will support industrial decarbonisation much more efficiently than free allowances - provided that green conditions are attached to funded activities such as the exclusion of fossil fuel investments like ‘grey’ or ‘blue’ hydrogen. There is a potential to multiply the impact of these funds, since in 2021 alone the Modernisation and Innovation funds will receive respectively 69 million and 40 million allowances, whereas free allowances will cost society 676 million allowances[3].
- **Accompany the phasing out of free allocation with a decarbonisation strategy**. Innovation in industry will drive the right investments and enable the take-off of decarbonised technologies. The EU must work to create a lead market for these technologies in Europe, so that we avoid locking-in fossil-based industrial assets which will last 20-30 years. As an important start, Carbon Contracts for Differences (CCfDs) must come as an alternative to free allocation of allowances, not as an additional subsidy.

Design a CBAM as a complement to ending free allocation

Alongside its proposal to revise the EU ETS, the Commission put forward a proposal to introduce by way of EU regulation a Carbon Border Adjustment Mechanism (CBAM), which would kick-in in 2023 and start functioning in 2026. The CBAM proposal is a climate policy measure, aiming at protecting EU companies' competitiveness and encouraging further climate action from non-EU countries. At the moment, free allocation under the ETS shields EU industries which are on the list of ‘sectors at risk of carbon leakage’ from paying a price for their emissions - despite the phenomenon remaining unproven[4]. Introducing a CBAM in replacement of free allocation could play different catalyser roles in contributing to EU’s industrial decarbonisation, and influence third countries to join the club, depending on how it would be designed[5]. Worryingly, and despite the fact that the Commission stated several times that the CBAM would be designed as an alternative to free allocation, the Commission has proposed the continuation of free permits to pollute for industry until 2035 - compared to 2030

[3] See WWF, “Fit for 2030: Optimising EU ETS revenues for people and climate”, June 2021.
[4] The carbon leakage list was implemented in 2013 and gives a higher share of free allowances to sectors, which qualifies as being at significant risk of carbon leakage compared to other industrial sectors.
[5] See WWF “WWF EPO’ views on the public consultation on the Carbon Border Adjustment Mechanism (CBAM)”, October 2020.

initially[6]. The Commission foresees a CBAM to live alongside and slowly accompany the phase out of free allocation between 2026 and 2035. Besides, the proposal suggests to use most revenues generated by CBAM to repay debt generated under the Next Generation EU. WWF calls on the co-legislators to:

- **Implement a CBAM as a complement to the ending of free allocation of allowances only**. A CBAM must not lead to double protection for EU industry nor prolong the free allocation regime. It should therefore replace the current carbon leakage protection measures applying to industrial sectors (i.e. cement, steel & iron, aluminium, fertilizers, and electricity) under art. 10(a) of the EU ETS directive.
- **Free allocation should end altogether as of 2023, the CBAM should kick-in fully at that time**. Keeping free allocation any longer - or removing them over 10 years as the Commission proposed - is too slow and would delay decarbonisation investments. No exception to the polluter pays principle means a simpler CBAM and better chances that it will be found WTO-compatible and non-discriminatory towards third countries.
- **Return the revenues raised by the CBAM to developing countries in the form of international climate finance**. As a CBAM would penalise third countries' industries with a lower emissions performance, it is only fair that the revenues raised are then redistributed to help industries reduce their carbon emissions. It will also make the CBAM more acceptable to international partners.

Allocating ETS revenues to real 'climate action'

A crucial improvement proposed by the European Commission is that all ETS revenues should be spent on climate action. However, what constitutes 'climate action' remains ill-defined and allows for fossil fuels to be subsidised through the EU ETS in the name of climate action. In the past, Member States have spent revenues dubbed 'climate action' spending on the modernisation of fossil fuel installations, carbon capture and storage, or fossil-based electricity by cancelling the carbon price (including through the article 10(c) derogation). Besides, risks remain that a substantial part of ETS 2.0 revenues taken from the most vulnerable is allocated to debt repayment or industrial decarbonisation, severing those who are the most affected by the ETS price from the benefits of the use of revenues. WWF calls on the co-legislators to:

- **Close the fossil-fuel loopholes in the definition of 'climate action'** by adding strong safeguards to the climate action spending categories in art. 10(3): funded activities should contribute to environmental action and '**do no significant harm**' (i.e. excluding fossil fuel investments)[7], prove consistent with National Energy and Climate Plans (NECPs) and Territorial Just Transition Plans (TJTPs), and comply with minimum social

[6] The EC mentioned several times that free allocation would not continue with the introduction of a CBAM. See for instance Executive Vice-President Valdis Dombrovskis: *"There cannot be double protection of EU industry in a sense that we continue to give free allowances and at the same time start putting additional burden on imported goods.",* Politico, 22 May 2021.

[7] For applying the 'do no significant harm' test to activities funded by ETS revenues, Member States could be required to follow the Commission (2021/C 58/01) technical guidance on the application of 'do no significant harm' under the Recovery and Resilience Facility Regulation.

safeguards included in the European Pillar of Social Rights. Revenues spent through the Modernisation and Innovation funds should comply with the same requirements.

- **Redistribute revenues fairly and effectively**: only revenues generated through the end of free allocation in the industry and aviation sectors should support industrial decarbonisation in the Modernisation and Innovation Fund; 100% of those generated by a potential separate ETS for road transport and buildings - in addition to a proportion from the existing ETS - should feed into the Social Climate Fund.

- **Oppose the use of ETS revenues for servicing public debt**, thereby preserving the redistributional aspect of ETS revenues.

Fixing the scope of the EU ETS

The purpose of the EU ETS is to reduce emissions through a price signal. The Commission's proposal makes timid progress on extending the scope of the EU ETS to international shipping, yet it failed to extend the EU ETS to international aviation, meaning flights departing to or arriving from outside the European Economic Area (EEA). Regarding the extension of the ETS to road transport and buildings, WWF expresses strong concerns about potentially significant negative social impacts. WWF calls on the co-legislators to:

- **Only move forward with the extension of ETS to road transport and buildings if strong environmental and social safeguards to the ETS extension to road transport and buildings are in place**: (i) demonstrate that the instrument has a relevant mitigation potential until 2030; (ii) introduce price control and reduce volatility through a price floor, a time-limited price ceiling, and a warning price/"red price zone" that triggers the obligation for further emission reduction efforts from member states; (iii) retain other legislation instruments covering these sectors, including the Effort-Sharing Regulation and the CO2 and cars legislation; (iv) full auctioning of allowances with no free allocation; (v) avoid negative distributional effects among Member States and ensure full redistribution of revenues raised towards affected and low income groups, to fully offset negative distributional impacts, potentially via the Social Climate Fund - revenues should not be spent on public debt or industrial decarbonisation; (vi) earmarking of revenues by Member States and accurate reporting on how ETS revenues were spent.

- **Extend the EU ETS to international shipping emissions earlier than 2026, by 2023**. Besides, **all emissions from extra-EU voyages should be included** in the EU ETS, and not just half of it as the Commission proposed.

- **Complete the extension of the EU ETS to international aviation** by fully covering all flights departing to or arriving from outside the European Economic Area (EEA) - instead of subjecting these extra-European flights to CORSIA as per the Commission's proposal. The CORSIA offsetting regime is unfit to regulate these emissions and achieve climate neutrality on time.

Improving the quality of Member States' ETS reporting

Despite a groundbreaking 2021 WWF report showing that reporting on the use of ETS revenues is overwhelmingly of poor quality - with Member States submitting cryptic, inconsistent or inaccurate information - the Commission has proposed little to improve transparency and accountability for how Member States spend EU ETS revenues. It proposed to partly resolve the issue of a lack of earmarking by deleting the sentence authorising Member states to use either ETS revenues "or the equivalent in financial value of these revenues" from article 10(3) of the EU ETS directive. Yet this improvement will not apply to ETS revenues from road transport and buildings, putting into question the additionality of any Member State's redistribution measures in these sectors. Furthermore, the Commission's proposal does not address the issue of the quality of reporting. WWF calls on the co-legislators to:

- Remove the provision authorising Member states to report either on the use of ETS revenues or on **revenues "which have a value equivalent to the revenues generated from the auctioning of allowances"**[8].
- **Revise reporting rules on the use of ETS revenues**[9] to ensure that Member States can only satisfy their reporting obligation if their yearly report contains complete, accurate and consistent information on the use of ETS revenues. The EEA or the Commission should be mandated to reject reports which do not live up to minimum quality standards.
- **Ensure earmarking and additionality of ETS revenues** by requiring Member States to monitor the use of ETS revenues under their state budget through a set of indicators proposed by the Commission showing how revenue is spent on climate action projects additional to those that would have been financed under their state budget.

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[8] See articles 10(3) and 30(5)(b) of the EU ETS directive and article 24 and Annex XIII of the Commission implementing regulation 749/2014.

[9] See articles 19 and Annex VIII of regulation 2018/1999 on the Governance of the Energy Union and Climate Action.