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The ESG Economist

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Stricter ETS to accelerate emission cuts

- **As part of the *'Fit for 55'* package, the EU ETS has been revised considerably**
- **The number of available emission allowances is being reduced at an accelerated pace**
- **Free CO2 allowances will be phased out fully by 2035 and will be replaced by a carbon border adjustment mechanism**
- **There will be a separate EU ETS for the Road Transport and Built Environment sectors**
- **EU ETS prices have not reacted much to the announcement, suggesting the stricter targets were priced in**

Fit for 55

This week, the European Commission (EC) announced its plans to implement the previously announced accelerated reduction of CO2 emissions. Last month, the EC laid down the ambition for accelerated reduction of CO2 emissions in legislation. CO2 emissions in the European Union are targeted to be reduced by 55% compared to 1990 levels by 2030 rather than the 40% goal previously. To realise this ambition, the Commission has drawn up plans to help the member states achieve their national targets. These plans include the introduction of a *Carbon Border Adjustment Mechanism* (CBAM), the accelerated increase of the percentage of renewable energy, higher energy efficiency and the tightening of the EU *Emission Trading Scheme* (ETS).

Through the ETS, companies receive or buy emission rights, which they can trade with each other as needed. These allowances can be traded on the financial markets and overall emissions decrease over time. This instrument is designed to reduce CO2 emissions by 2050 to achieve a carbon-neutral economy. In this article we look at the adjustments to the EU ETS, the expansion of the sectors it covers and the possible consequences of this. The total emission reduction of the sectors covered by the EU ETS is targeted at 61% in 2030 compared to 2005.

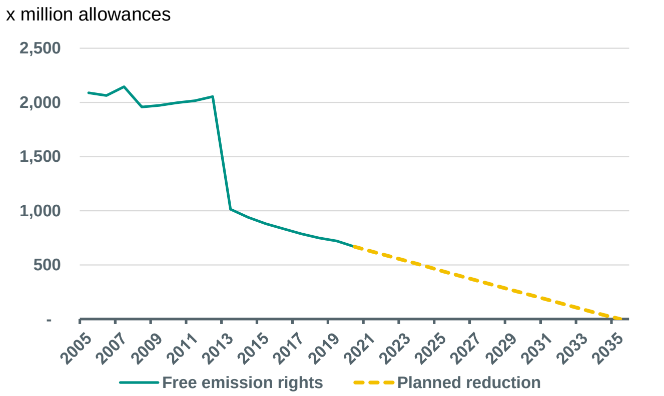
The ETS focuses on the electricity, industry and aviation sectors (within the EU). With this adjustment, shipping (*maritime transport*) will be added from 2023 onwards. To ensure a smooth transition period, the sector will initially only have to offset part of its emissions with emission allowances. This will gradually increase to 100% over four years. The existing ETS will be expanded by 90 million tonnes or CO2 allowances to limit the impact on other sectors.

End of free rights in sight...

Since the start of the EU ETS in 2005, free allowances have been given to companies. The idea behind this is that there are some companies that are slower than others to make their processes more sustainable. It also protects part of the industry against unfair competition from countries where there is no price on CO2 emissions. Companies that have free allowances left over because they have reduced the carbon intensity of their production can sell these allowances to others. In addition, companies can buy emission allowances at the daily auction. The free, auctioned and traded allowances together form the market.

In the 'Fit for 55' plans, the EC has indicated that it will accelerate the phasing out of free emission allowances between 2025 and 2035. Instead, the EC wants to introduce the CBAM. The basic aim of the mechanism is to make sure that the imported goods face the same cost of carbon emissions as domestically-produced goods do, in order to prevent 'carbon leakage'.(we will publish a separate note on this mechanism shortly). To give companies time to adjust to the new measures, there will be a transition period during which the number of free allowances will be phased out, while the CBAM is phased in. This will apply to the steel, aluminium, cement, fertiliser and the electricity sectors. In 2020, just under 668 million free allowances were still being given away in Europe. This will be reduced linearly by 10 percentage points per year from 2025 until there are no more issues in 2035.

Free allowances will be phased out until 2035

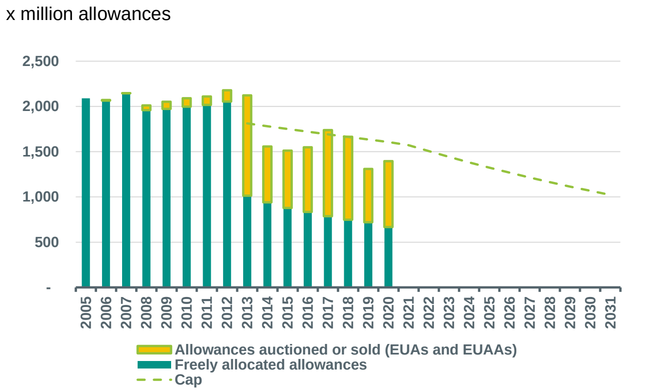


Source: European Environment Agency

... and the ceiling on the maximum number of allowances will fall more rapidly

Looking forward, as the number of free allowances decreases, the role of auctions of emission allowances and trading on the financial market of these allowances will become even more important. In order to further accelerate the process of sustainability in order to reach the climate targets, the EC has also decided to reduce the number of available emission rights. They do this in two-steps Firstly, the number of rights will be limited by reducing the ceiling at an accelerated pace. In addition, a number of allowances will be taken out of the market on a one-off basis.

Ceiling of available allowances will fall faster



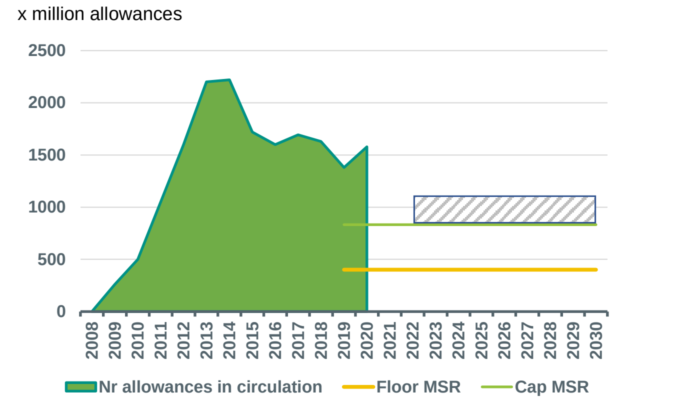
Source: European Environment Agency

In the previous trading phase of the EU ETS (2013-2020), the maximum number of allowances available already decreased by 1.74% per year. In the current phase (2021-2030) this reduction was already increased to an annual rate of 2.2% to meet the 40% CO2 reduction target in 2030. Now that this target has been adjusted to a 55% reduction, the EC has decided to reduce the cap by 4.2% annually. Since the actual implementation of the 4.2% reduction will take some time, a one-off reduction in the number of emission allowances will follow. The net effect will then be the same as if the 4.2% reduction had taken effect in 2021. The accelerated phase-out combined with the one-off reduction in the number of emission allowances available will ensure that the targets set for the sectors covered by the EU ETS will be met. As the EU ETS aims at net-zero emissions in 2050, allowances will still be available at auction and in day-trading after 2030.

Market Stability Reserve Adjustment

The *Market Stability Reserve* (MSR) is an instrument designed to bring stability to the EU ETS market. The instrument was launched in 2019 to (temporarily) remove surplus emission allowances from the market. In previous years (2014-2016) a *backloading procedure*, or the one-off removal of surplus emission allowances from the market, was used. With the MSR, the supply-demand balance has been structurally managed, and the prices of EU ETS allowances could rise. If there are too many emission allowances in circulation, less allowances will be auctioned. If there is a shortfall (less than 400 million allowances in circulation), allowances will be released from the MSR. The number of allowances in circulation is calculated as: supply - (demand (including cancelled allowances) + allowances in the MSR).

MSR ceiling will be adjusted



Source: European Environment Agency

The announced EC plans also include a tightening of the MSR. The take-up quota is modified to address the "threshold effect" that would occur when the total number of allowances in circulation is very close to the upper threshold. In that case, one allowance more or less may or may not lead to a take-up. Uncertainty about whether this could happen could cause price volatility in the market. The proposal changes this mechanism. The proposal creates a buffer for allowances when the number of allowances in circulation is between 833 million and 1096 million (see shaded area in the graph above). In this case, all allowances above the threshold of 833 million but below 1,096 million will be taken up. If the number of allowances in circulation exceeds 1096 million, the normal percentage of allowances taken out of the market would apply (24% of the auctioned volume until 2030). In addition, a minimum number of allowances (200 million) must be added annually to the MSR.

New ETS for the road and built environment sectors

The existing trading platform focuses on the electricity sector, industry, aviation (within the EU) and soon also on maritime transport. In addition to the adjustments to the existing EU ETS, there will be a new emissions trading system from 2025 specifically aimed at the road transport and built environment sectors. The system is the same, however. A number of emission rights are available and these will be increasingly limited from 2026 onwards. If companies do not become more sustainable, prices will rise as a result of the scarcity that has arisen. This will have to provide a stimulus so that sustainability still becomes the better alternative.

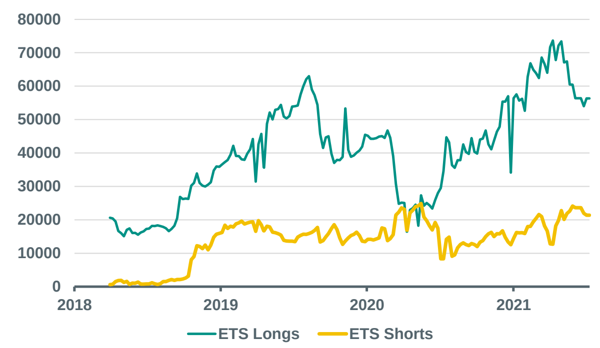
The built environment is directly and indirectly responsible for 36% of energy-related greenhouse gas emissions in the EU. Half of this - the use of electricity - is already covered by the existing EU ETS. However, many households also use coal, oil and gas. Road transport accounts for about 20% of greenhouse gas emissions and has grown 25% since 1990. The bill does not fall on the end user, but on the parties selling the fuels. Nevertheless, it is likely that the some proportion will be passed on to the end user.

Impact and the EU ETS price

After the publication of these plans, it is up to the member states, the Council of the EU and the European Parliament to come up with definitive legislation. This presentation is the starting point of possibly years of negotiations on the exact details for countries and sectors. Some countries, like Germany, Sweden and Denmark, welcome the ambition for further acceleration of CO2 emissions and higher CO2 prices. Other countries are less enthusiastic. With Poland in the lead, and countries like Romania, Bulgaria and the Baltic States right behind it, it seems that the plans will not be adopted 1-on-1 without a fight. But resistance is also visible within sectors. In Germany, the plans for phasing out the sale of new petrol and diesel cars by 2035 have not been well received. In France, they are worried about higher costs for the consumers and fear renewed protests.

Market speculation has increased in recent years

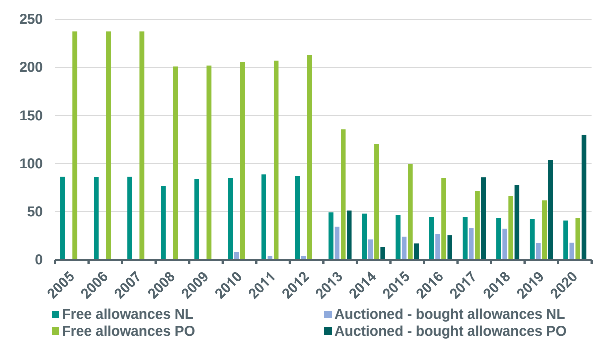
x number of contracts



Source: Bloomberg

Ratio of free rights to purchased rights

million tonnes CO2 equivalent



Source: European Environment Agency

Since 2018, speculation in these EU ETS emission rights has increased sharply. As can be seen in the chart above, the outstanding contracts for long positions (speculating on price increases) in particular have expanded considerably. With a decreasing number of emission allowances in circulation and an increasing number of parties speculating on price developments, price volatility could increase further in the coming years. This is something that countries like Denmark and Poland have indicated to the EC. However, these plans do not include measures to combat market speculation. As can be seen from the right-hand chart above, Poland already has a much greater dependence on auctioned and purchased emission allowances than for instance the Netherlands. Their exposure to volatile market prices is therefore already higher than in many other (often north-west European) countries. Though even in these countries this ratio will change dramatically in the coming years, increasing their exposure to market price movements.

Rapid price increases do not in any case help the energy transition and the measures to reduce CO2 emissions. Money that should actually be used to invest in sustainability must then be paid for by purchasing emission rights. And the effect will only be limited if governments pass it on 1-on-1 to these companies. If this is not done, companies that stay behind and want to invest will be disadvantaged by the speed of the CO2 price increase. In order to stimulate this, the EC has proposed that the revenues of the EU ETS should no longer be paid to the member states but to the EU. After which the member states have to use the revenues allocated to them for climate-related purposes.

The direct impact on EU ETS prices was limited after the announcement of the changes to the scheme. To some extent, prices had already factored in the stricter regime given that it was a clear implication of the more ambitious emission reduction goal, which was announced earlier. The medium term outlook prices will depend crucially on developments in renewable energy technology. In terms of the current state of play, higher carbon prices would be necessary to make some technologies – for instance green hydrogen – economical.

ETS price has already risen in anticipation of these plans

Source: Bloomberg

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