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## A robust and efficient emissions trading system is key for decarbonising the European economy

**Fortum's proposals for the EU 2030 climate regulation: Emissions Trading Directive (ETS), Effort Sharing Regulation (ESR) and land use, land-use change and forestry regulation (LULUCF)**

### Fortum's key messages

Fortum firmly supports increasing the EU 2030 climate target to at least 55%. The new target must be allocated between ETS and non-ETS sectors based on cost efficiency. Synergy of the climate target with renewable and energy-efficiency targets must be ensured.

The EU emissions trading system (ETS) must remain as the main instrument of the EU climate policy. The system must be further reinforced and extended in order to be able to deliver on the increased climate ambition.

The ETS should be reinforced by revising the linear reduction factor (LRF) in line with the revised 2030 target by 2023 or 2024 at the latest. The market stability reserve (MSR) should be revised by continuing the 24% intake rate after 2023 and adjusting the activation thresholds (400 and 833 Mt).

The ETS should be extended by establishing a stand-alone transitional trading system for the new sectors in order to safeguard the operation of the existing ETS. Potential sectors for the extension include maritime, heating of buildings and, in the longer run, waste incineration.

Double coverage of sectors has to be avoided. Each sector should be included only under one climate policy pillar (ETS, ESR, LULUCF). The coverage of the effort sharing sector (ESR) should be gradually reduced and related activities moved to the ETS and LULUCF (land use, land use change and forestation).

The flexibilities between ETS, ESR, LULUCF should not be increased; the aim should be that each climate policy pillar delivers credible reductions on a stand-alone basis.

Separate targets for greenhouse gas emission reductions and carbon removals, including all forms of natural and technical solutions, are needed. A legislative EU framework for technological solutions for carbon removal and negative emission technologies should be incorporated into the Fit for 55 package.

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## ETS has been a success, but there is potential for more

The EU ETS has proven to be an effective tool in reducing greenhouse gas emissions. Emissions in the EU ETS declined by 33% between 2005 and 2018, while emissions outside the ETS fell by just 11%. Since the beginning of the ETS 15 years ago, emissions from power generation in Europe have nearly halved.

Significant progress has been achieved in improving the design and functionality of the EU ETS over the past three years. As a consequence, the price of carbon reached an all-time high at the beginning of 2021. But there is potential for more. That is why we support the Commission initiative to reform the ETS in order to make it an even more efficient tool in reducing emissions by at least 55% by 2030.

## Building blocks for a robust and efficient ETS for the future

Well-functioning, market-driven, technology-neutral and flexible emissions trading system is the most cost-efficient instrument to decarbonise the European economy. To be able to deliver on the increased climate ambition, the ETS must be further strengthened and expanded. We see the following elements as central to a robust and efficient ETS for the future:

(click for more information):

- **Make the ETS a more efficient tool for reducing emissions.** If we want to reduce emissions quickly, we must focus on sectors that can provide the most significant results in the most cost-efficient way.
- **Ensure synergy with renewable and energy-efficiency targets.** These are interlinked, so it is important to avoid policy overlaps and unintended consequences.
- **Strengthen the ambition of the ETS.** An increase of the linear reduction factor (LRF) would be the most appropriate option. Auctioning should be the preferred option, and the amount of free allocations should be decreased.
- **Revise the market stability reserve.** Adjustment of the intake rate and thresholds are key to increasing the stability of the ETS.
- **Extend the ETS to new sectors.** Inclusion of maritime, heating of buildings, and later on also the waste incineration sector in the ETS should be studied. Ensure a level playing field and coherence with other policy measures when extending the ETS to new sectors. New sectors should not disrupt and undermine the stability of the current ETS.
- **Avoid double coverage of sectors.** Each sector should be included only under one climate policy pillar (ETS, ESR, LULUCF). The ESR sector should be gradually phased out and moved to the ETS and LULUCF.
- **Address the risk of carbon leakage and harmonise compensation for indirect costs.** The Commission should continuously assess the risk for real carbon leakage and revise carbon leakage policies accordingly. Sectors exposed to the risk of carbon leakage due to indirect costs should be compensated equally in all member states.
- **Set stricter requirements on the use of auctioning revenue** to support innovation, clean investments in the ETS sectors, energy efficiency, low-carbon mobility, and green consumption.
- **Support technological solutions for carbon removal.** The EU needs a legislative framework for technological solutions for carbon removal and negative emission technologies.

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### **Make the ETS a more efficient tool for reducing emissions**

The EU has agreed to reduce emissions by at least 55% by 2030. The Commission needs to prepare an analysis on the most cost-efficient pathway to meet this new ambition. All sectors need to contribute. The key issue is the allocation of the new 2030 target between the three sectors: the current ETS sectors (power and heat generation, energy-intensive industry sectors, and intra-EU aviation), the sectors currently outside the ETS and subject to emission reductions under the ESR (for example, transport, agriculture, waste, and buildings), and carbon sinks related to land use and forestry (the LULUCF sector).

The ETS sectors should bear the largest burden and increase their emission reduction efforts in line with the new target. Based on previous cost-efficiency calculations by the Commission,<sup>1</sup> the current ETS sectors should contribute around -63% compared to 2005 (currently the ETS target is -43%).

### **Ensure synergy with renewable and energy-efficiency targets**

The EU's renewable energy and energy-efficiency targets are closely interplaying with the target for greenhouse gas emission reductions. It is important to assess the interlinkage of various targets and to find the most cost-efficient pathway to reach the revised 2030 climate target. Special attention should be paid to the impact of renewable energy and energy-efficiency targets on the EU ETS and on the need to revise the existing 2030 renewable energy and energy-efficiency targets. Any policy overlaps with the ETS must be mitigated.

### **Strengthen the ambition of the ETS**

The linear reduction factor (LRF) of the ETS has to be revised in line with the revised 2030 climate target and the 2050 climate-neutrality goal as soon as possible, by 2023 or 2024 at the latest, in order to give predictability to the ETS, provide a necessary signal for low-carbon investments, and minimise cumulative emissions in the atmosphere. In addition, the emission reduction pathway after 2030, including a possible intermediate target for 2040, must be defined as soon as possible.

Key parameters affecting the LRF revision include the starting year (the year from which the cap is to be revised), the scope of the ETS (possible ETS extension), and a possible rebasing (the baseline level from which the LRF is applied).

In view of a strengthened ETS cap, the auction share should be increased and free allocation decreased.

### **Revise the market stability reserve**

The Market Stability Reserve, introduced in 2019, addresses the current surplus of allowances and adjusts the supply of allowances to be auctioned. It has reinforced the stability of the ETS, but should be further reformed as part of the system.

Continuing the 24% intake rate until the end of 2030 and continuing the annual invalidation of allowances from the reserve should have a high priority in the revision. It is also important to address the impacts of other targets (renewables, energy efficiency) on MSR operation.

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<sup>1</sup> Impact Assessment accompanying the Communication on stepping up the EU's 2030 climate ambition

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The MSR thresholds (400 and 833 Mt) triggering adjustments to annual auction volumes have a significant influence on the effectiveness of the MSR and should be updated to reflect an increasingly decarbonised economy and the gradually declining hedging requirements in the power, industrial and aviation sectors. The MSR thresholds should be more dynamic and take into account the ETS cap.

### **Extend the ETS to new sectors**

In order to maintain the flagship role of the ETS, it is important to include more sectors under the ETS cap.

The Commission should study the inclusion of maritime and heating of buildings in the ETS. Including heating of buildings in the EU ETS would provide a level playing field for all modes of heating and cooling.

In the longer run, inclusion of waste incineration sector could also be considered, provided that greenhouse gas emissions from landfilling are also included in ETS and the whole value chain of fossil materials and waste production are subject to a similar steering mechanism.

Immediate integration of the new sectors in the current ETS might disrupt and undermine the stability of the current ETS. Therefore, the impact assessment should consider establishing a stand-alone transitional trading system for the new sectors vs. integrating them directly into the current ETS. Transitional arrangements would allow for the gradual set up of the required regulatory framework and administrative capacity. The ultimate goal, however, should be a single trading system.

The ETS cap should be adjusted in connection with the extension and take into account the new scope and the existing allowance surplus in the market.

Carbon pricing alone does not address all barriers to the deployment of low- and zero-emissions solutions. Extending the ETS to new sectors should – at least in the beginning – be complementary to other sector-specific policies, including energy-efficiency policies, energy taxation, and renewable energy policies.

Bringing sectors like heating of buildings into the ETS would increase the price for consumers, and such price increases may have unfortunate distributional impacts especially on lower-income households.

### **Double coverage of sectors to be avoided**

In reorganising the EU's three-legged climate policy (ETS, ESR, LULUCF), a general principle should be avoidance of double coverage. Each sector should be included only under one policy pillar. If a sector is transferred from the ESR sector to the ETS sector, it should be removed from effort sharing in order to avoid overlapping policies.

The flexibilities between ETS, ESR, LULUCF should not be increased; the aim should be that each climate policy pillar delivers credible reductions on a stand-alone basis.

### **Address the risk of carbon leakage and harmonise compensation for indirect costs**

Fortum recognises that existing carbon leakage measures (free allocation of allowances and compensation of indirect costs of the ETS) no longer reflect the current situation nor the future emission reduction scenarios envisaged by the European Commission. In the light of the EU 2050 climate neutrality target, the Commission should continuously assess the risk for real carbon leakage and revise carbon leakage policies accordingly.

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In our view, for selected sectors (like the power sector), the current carbon leakage framework should be replaced with a Carbon Border Adjustment Mechanism (CBAM). The CBAM should be an alternative to the existing carbon leakage measures.

Two of four options presented in the earlier CBAM public consultation are connected to the ETS. The upcoming revision of the ETS must take into account these options and study their impact on the ETS. As a general principle, the CBAM should not undermine the effectiveness and operation of the ETS.

The rapidly ongoing decarbonisation of the electricity production in the EU will sufficiently reduce indirect costs; therefore, indirect cost compensation can be gradually phased out. Meanwhile, indirect cost compensation should be further harmonised in Europe: sectors exposed to the risk of carbon leakage due to indirect costs should be compensated equally in all member states.

### **Set stricter requirements on the use of auctioning revenue**

Under the revised ETS, member states should be required to spend more revenues on climate-related purposes. The ETS should also include more specified and more permanent rules on the use of auctioning revenues. In our view, ETS revenues should be used for innovation and clean investments, in particular supporting technologies that need scaling up (hydrogen, carbon capture and storage/utilisation).

Currently, ETS revenue is mostly reserved for the use of national governments. We are concerned about the proposal to use part of the auctioning revenues for the EU's own resources. We support the recycling of revenues into climate-related projects and believe that directing the EU ETS revenue into general expenditure is not the right approach.

The size of the Innovation Fund should be increased by using more allowances both from the auction share and the free allocation share. Currently, the ETS Directive foresees that the maximum funding rate for projects financed by the Innovation Fund is 60% of the relevant costs. This rate could be increased, but only in case of competitive bidding, e.g. Carbon Contracts for Difference, whereby beneficiary projects, especially in hard-to-abate sectors, would be guaranteed a fixed carbon price if the ETS price is not high enough.

The size of the Modernisation Fund should remain at 2% of the cap, but the types of investments that can be financed by it should be streamlined. For example, the exception for financing coal-fired district heating in certain member states should be removed.

### **Support technological solutions for carbon removal**

Fortum believes that CO<sub>2</sub> removal and negative emission technologies (e.g. bioenergy with carbon capture and storage, BECCS) are a key complement to the EU's existing climate change mitigation tools as well as necessary for reaching net negative emissions after 2050. Carbon sinks (both natural and technological) should be additional to emissions reduction. Separate absolute targets for greenhouse gas emission reductions and carbon removals are needed. In order to make carbon removal and negative emissions technologies commercially viable and to upscale them, they should be incentivised. They should be better recognised in legislation and, preferably, promoted by market-based tools, like carbon pricing. An appropriately designed EU policy framework can support and incentivise the development of cross-border CO<sub>2</sub> transport and storage networks in Europe.

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The revision of the ETS, ESR and LULUCF regulations in 2021 is a key opportunity to establish a legislative framework for technological solutions for carbon removal and negative emission technologies. The upcoming Impact Assessments on ETS, ESR and LULUCF should take into account these technologies and study the options to integrate them into the EU climate policy framework.

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