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REINFORCED AND EXTENDED EMISSIONS TRADING SYSTEM SHOULD TAKE THE MAIN RESPONSIBILITY FOR THE EU 2030 CLIMATE AMBITION INCREASE

Fortum's response to the consultation on the EU 2030 Climate Target Plan

Key messages:

- Following the adoption of the 2050 climate neutrality target, a cost-efficient emissions reduction pathway from today towards 2050 should be established, including intermediate targets for 2030 and 2040. Fortum supports increasing the 2030 GHG reduction target to 50-55%. A swift decision would increase the predictability of European climate policy, provide a necessary signal for low-carbon investments and minimise cumulative emissions into the atmosphere.
- Following the adoption of the revised 2030 target, the increased ambition has to be allocated between the three sectors (ETS, ESR, LULUCF). A reinforced and extended EU ETS sector should take the main responsibility for the increased climate ambition. Most emissions reduction efforts are needed in buildings, industry and transport, where electrification will be a key solution to decarbonisation.
- A more ambitious EU 2030 target should be accompanied by the most cost-efficient policy measures, and overlapping policies should be avoided. Due to the high technological uncertainties involved with deep decarbonisation, the emissions target alone should drive low-carbon investments after 2030.
- Uniform carbon pricing for all sectors should be the goal when designing measures to achieve economy-wide climate neutrality by 2050. Extending the ETS to sectors that are currently under ESR would be a step in this direction and could increase the cost efficiency of emissions reduction. Potential sectors for extension are heating & cooling and transport.
- The scheduled revision of the EU ETS in 2021 should focus on 1) increasing the LRF in accordance with the 2030, 2040 and 2050 targets, 2) adjusting the MSR parameters, and 3) extending the scope of the system and adjusting the ETS cap accordingly.
- In sectors remaining outside the ETS, a mix of policy measures would be the most feasible solution with carbon price as the centrepiece and complemented with national taxation and other policy measures. The revision of the Energy Taxation Directive in 2021 should focus on developing taxation based on CO₂ emissions.
- The 2030 target setting should take into account carbon removals and negative emissions. Carbon removals and negative emissions should be integrated into EU climate legislation giving incentives for the deployment of these technologies.

ETS = Emissions Trading System
 ESR = Effort Sharing Regulation (non-ETS sectors)
 LULUCF = Land Use, Land Use Change and Forestation
 MSR = Market Stability Reserve of the ETS

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Climate science has defined a carbon budget for humanity to keep global warming below 1.5-2 °C and this goal has been enshrined in the Paris Agreement. The EU should set targets and implement policies accordingly. Fortum strongly advocates the recently agreed EU objective of achieving climate neutrality by 2050.

Climate ambition for 2030 to be swiftly increased

Following the 2050 target, a cost-efficient emissions reduction pathway from today towards 2050 should be established, including intermediate targets for 2030 and 2040. The focus should be on early action and on the adoption of the new 2030 target as soon as possible. Any delay in the approval will lead to more cumulative emissions being released into the atmosphere. A prompt decision is also needed to bring long-term predictability to the European climate policy and to provide a necessary signal for low-carbon investments.

Fortum supports increasing the 2030 GHG reduction target to 50-55%. In this context, we highlight the fact that the intermediate climate targets for 2030 and 2040 should take into account cost efficiency, effectiveness and fairness of GHG emissions reduction that would allow the transition to be made in a just and socially fair manner.

Increasing the EU's climate ambition would be beneficial as it would strengthen the EU's leadership in global climate action while incentivising transformation of the EU economy based on new production and consumption models (e.g. circular economy) and green jobs. Health benefits linked to a higher climate ambition would also be notable. In addition, a higher climate ambition will give EU industry a first-mover advantage in global markets.

Extended EU ETS should take the main responsibility for the increased ambition

Until now, progress in emissions reduction has been faster in the Emissions Trading System (ETS) than in the sectors regulated by the Effort Sharing Regulation (ESR). Between 1990 and 2018, ETS emissions have decreased by 23% whereas ESR emissions by only 10%.

In the context of an increased climate target for 2030, a holistic and non-discriminatory decarbonisation strategy across all sectors has to be developed. So far, the electricity sector has been in the focus of the European emissions reduction efforts. In the way forward, most efforts are needed in buildings, industry and transport, where electrification will be a key solution to decarbonisation. It will also be necessary to foster sector integration and carbon-neutral power-to-X technologies.

To speed up electrification, the EU should stimulate the demand of CO₂ free products, e.g. CO₂ free steel, cement and fertilizer. This would promote the development of hydrogen economy that together with higher carbon price would drive the industry transformation and give EU industry a possibility to take a lead in this transformation.

Following the adoption of the revised 2030 target, the key issue is the allocation of the increased ambition between the three sectors (ETS, ESR, LULUCF). In Fortum's opinion, the reinforced EU ETS with an extension to some new sectors (e.g. heating and cooling) should take the main responsibility for the increased emissions reduction effort in 2030.

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Emissions reduction target alone to drive low-carbon investments post-2030

Along with more ambitious EU targets, cost efficiency of emissions reduction and avoidance of overlapping policies is increasingly important. The EU's current three-target approach (GHG, renewables, energy efficiency) needs to be carefully reconsidered. Existing 2030 targets for renewable energy and energy efficiency should remain unchanged. Due to the considerable uncertainty over technological, societal and other pathways, the emissions reduction target enforced through carbon pricing would constitute the most cost-efficient, low-risk and flexible tool to drive low-carbon investments after 2030.

Carbon pricing to be the leading instrument in all sectors

Fortum prefers consistent carbon pricing as the leading climate instrument across all sectors of the economy, supporting the EU's economy-wide carbon neutrality by 2050. Carbon pricing is key both for cost-efficient emissions abatement and climate financing.

The EU ETS has proven its effectiveness as an instrument in setting a binding carbon budget and steering the development of emissions: in 2019, the use of coal in power production in Europe decreased by almost a quarter compared to the previous year, as the price of emissions allowances tripled. Emissions trading began 15 years ago; since then, emissions from power generation in Europe have nearly halved.

Carbon pricing, while increasing the costs of energy, also offers the possibility to generate public revenues. EU ETS revenues will contribute to support the transformation of the European economy. Revenues can be recycled via reductions, e.g. in labour taxes, and they can also be used to compensate for low-income households or other vulnerable groups.

In non-ETS sectors, we support a mix of policy measures with carbon price as the centrepiece and complemented with taxation and other policy measures. The revision of the Energy Taxation Directive in 2021 should focus on developing taxation based on CO₂ emissions.

Climate and energy policy framework to be redesigned

ETS parameters (LRF, MSR) to be strengthened

Significant progress has been achieved in improving the design and functionality of the EU ETS over the past three years. However, the system has to be further revised in order to be able to deliver on the increased climate ambition, to maintain resilience in the face of the COVID-19 induced economic crisis and to contribute to Europe's green recovery.

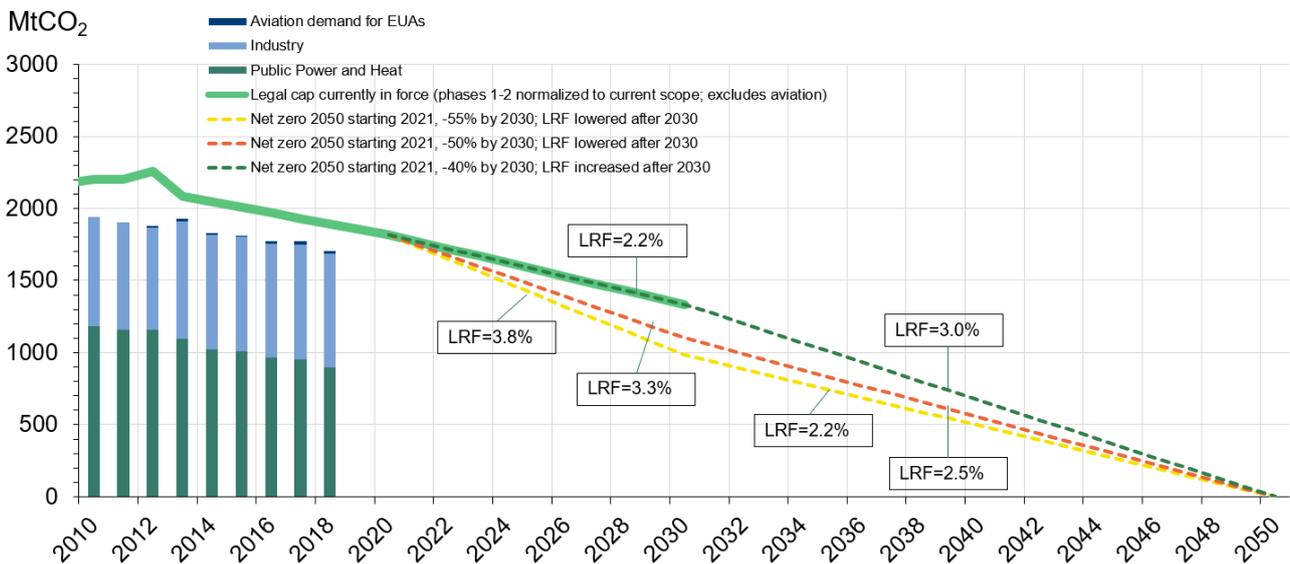
The EU needs to ensure the long-term credibility of the ETS as the flagship climate policy instrument. Evidence shows that even during periods of low allowance prices, the EU ETS delivers emissions reductions as long as market participants see the potential for higher prices in the future.

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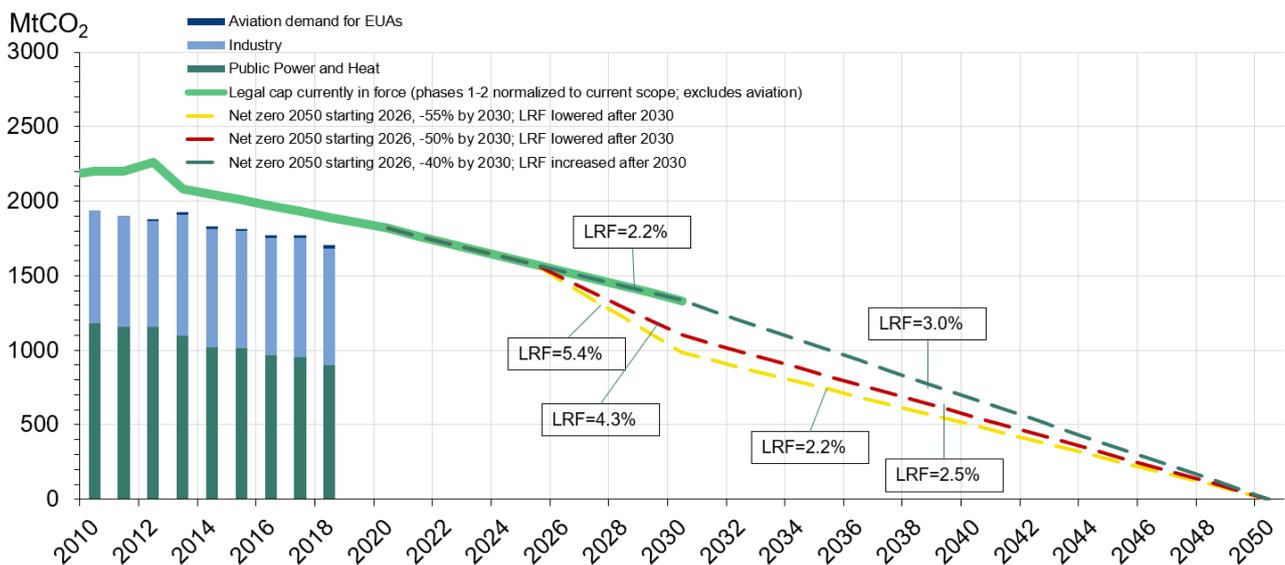
The simplest and most effective way to translate the new 2030 target to the EU ETS is by changing the Linear Reduction Factor (LRF). The adjustment to the LRF should take place in connection with the ETS review in 2021.

The following graphs indicate the LRF levels needed to meet the 2030 and 2050 targets, assuming the current scope of the ETS and the existing split of the emissions reduction target between the ETS and non-ETS. The graphs illustrate clearly the importance of timing in tightening the LRF.

A) Tightening of LRF in 2021



B) Tightening of LRF in 2026



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In addition to increasing the LRF, strengthening the design parameters of the MSR will be essential to manage the short- and medium-term excess supply of allowances in the ETS. We support continuing the 24% intake rate until the end of 2030 and continuing the annual cancellation of allowances from the reserve. The thresholds in the MSR hedging band (400 and 833 Mt) have a significant influence on the effectiveness of the MSR and should be updated to reflect an increasingly decarbonised economy and gradually declining hedging requirements.

ETS extension to increase the economic efficiency of emissions reductions

Currently, the ETS covers about 40% of the EU GHG emissions, but this share is expected to decrease to 35% by 2030. In order to maintain the flagship role of the ETS, it is important to include more sectors under the ETS cap.

The higher we raise the 2030 target, the higher a burden it will be for non-ETS sectors that have an increasingly important role in the total decarbonisation of society. However, these sectors are generally costly to decarbonise and this highlights the cost-effectiveness of emissions reduction policies in these sectors.

As the EU ETS is the most cost-effective policy instrument at the EU's disposal, grounds for its extension are evident. Fortum supports the extension, especially to the heating and cooling sector, and welcomes the work launched by the Commission to study extending the ETS to buildings and transport. The extension to buildings could be realised by setting the ETS compliance obligation to the suppliers of heating fuels and by reviewing the existing taxation of heating fuels.

The extension of the ETS to new sectors will increase the economic efficiency of emissions reductions and will help the EU to achieve its climate and environmental objectives. 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.

Extending the ETS to road transport and buildings should – at least in the beginning – be complementary to other sector-specific policies, including taxes, duties and charges already in place. Policy overlaps as such are not optimal, but they should not be allowed to delay or prevent the necessary extension of the EU ETS.

Carbon removals and negative emissions to be incentivised

As the global carbon budget is diminishing and the climate targets are tightening, the role of CO₂ removal and negative emissions will increase. Both the IPCC scenarios and the EU's "Clean Planet for All" strategy highlight their role in achieving carbon neutrality. However, European legislation currently poorly recognises the technological solutions for carbon removal and negative emissions and does not provide any economic incentives for their deployment.

The 2030 target setting should take into account carbon removals and negative emissions and these should be integrated into the revision of legislation (ETS, ESR, LULUCF) in 2021. As the first step, the EU needs to define what qualifies as a removal and storage, and how long the CO₂ needs to stay away from the atmosphere. Member states should be also required to report carbon removals and negative

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emissions in the National Energy & Climate Plans (NECPs) in the framework of the Governance Regulation.

In Fortum's opinion, incentivising CO₂ removals and negative emissions in the EU ETS would be the most feasible option. This could be done by allocating free emissions allowances to installations removing carbon dioxide. This allocation volume should be taken from the auctioning volume in order to not weaken the steering impact of the EU ETS.

Alternatively, the EU could develop a consistent framework for incentivising CO₂ removal in the Effort Sharing Regulation.

Carbon leakage to be addressed in the context of the higher climate ambition

Along with the higher climate ambition, the carbon leakage risk in the ETS sectors (especially industry and power) is increasing. Fortum supports the ongoing Commission's work on assessing a carbon border adjustment mechanism focused on environmental integrity and competitiveness.

The power sector observes increased cross-border power trading and imports from third countries with higher carbon content, requiring the investigation of a carbon border adjustment mechanism. The import of power differs from the import of industrial goods; hence also the solutions for carbon border adjustment in the power sector should differ from solutions in industrial sectors.

EU to use its climate diplomacy to promote carbon pricing globally

The EU currently represents less than 10% of global emissions. All regions of the world have to contribute to climate action. In the international climate negotiations, we call for the EU to promote the market mechanisms of the Paris Agreement to deploy effective carbon pricing. Effective market solutions and tradable emissions allowances could motivate other countries to also step up their climate ambitions.

The EU should actively enhance carbon pricing globally. As the first step, regional carbon pricing mechanisms should be linked with the EU ETS, and the ultimate goal should be for the most comprehensive global carbon pricing and emissions trading. This could prevent carbon leakage and ensure the equal competitive position of European industry.

For further information:

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