Reformed EU carbon market could boost revenue for climate action

Published 14-Jul-2023 by
Julia Michalak, EU policy director, International Emissions Trading Association

The International Emissions Trading Association (IETA) believes well-designed carbon markets are pivotal to achieve the net-zero target.

The EU Emissions Trading System (EU ETS) is a world-leading carbon trading system that has reduced emissions from power and industry by almost 35% since launching in 2005.

It caps specific greenhouse gases that participants can emit and converts that cap into tradable emission allowances. One allowance gives the right to emit 1 ton of carbon dioxide equivalent. While the power sector must purchase all required allowances at auction, with a temporary derogation for producing electricity in Central and Eastern Europe, industrial sectors risking carbon leakage are entitled to free allocation. To optimise costs, market participants can either reduce emissions or buy allowances.

Cornerstone of EU climate action

Over the last two decades the EU ETS was subject to several reviews to fine-tune its parameters and improve its effectiveness. The most recent reform, approved by the EU in April 2023, occurred under the "Fit For 55" package of policy initiatives, which paved the way for achieving the EU's 2030 goal of cutting emissions by 55%. Recently legislated changes to the EU ETS include a steeper emission reduction trajectory, rebasing of the cap, expansion to new sectors and strengthening the Market Stability Reserve (a mechanism delivering market scarcity).

Moreover, the EU will establish a separate ETS 2 system for trading emissions from road transport, buildings, and industrial combustion. Together, the EU ETS and ETS 2 regimes will cover almost 76% of EU emissions, confirming the bloc's commitment to carbon trading as a mechanism for achieving carbon neutrality.

Climate transition revenues

Carbon markets not only guarantee that environmental goals can be reached cost-efficiently; they also generate revenues that can be used for further mitigation. In the EU, ETS revenues were once directed mostly to member states that were merely encouraged to spend them on climate action. Recent reforms, however, strengthened provisions governing the use of auction revenues. Member states are now obliged to spend all ETS revenues for climate purposes, except those used for compensating industries for increasing indirect costs.

Additionally, the Commission proposed that part of the revenues will be redirected to the Union budget. They will be used for NextGenerationEU, the EU's temporary instrument for boosting economic recovery from the COVID-19 pandemic, and to finance the Social Climate Fund designed to ensure a fair and just climate transition.

EU ETS auctioning revenues have almost doubled in the last two years, due to a significant increase in the price of allowances. In 2021, as much as 25 billion euros from allowance sales went directly to member states. In 2022, that amount increased to 30 billion euros and is expected to grow further in years to come.

The European Commission's revised assumptions set the average EU ETS carbon price at around 80 euros per ton (in 2020 prices) for the period 2023-2030, compared with the 45-55 euros assumed in the 2020 Impact Assessment, a technical analysis accompanying the EU ETS Review proposal.

From 2028, ETS 2 will provide a new stream of revenues. The Commission estimates the price of allowances in ETS 2 will average around 45 euros in the period 2027-2030 (in 2020 prices). Due to the combined impact of the EU ETS MSR absorbing/cancelling allowances and the cap rebasing, as well as the significant size of ETS 2, it is expected that, in the years 2028-2030, ETS 2 will generate more revenues than ETS.

For 2023-2030, total projected revenues from auctioning ETS and ETS 2 allowance will reach nearly 400 billion euros (in current prices). From that sum, the Commission initially proposed transferring 75% to member states and directing the rest toward the EU budget. Just a few weeks ago, however, the Commission presented a revised proposal that would increase the share directed toward the EU budget to 30%. That proposal will now be negotiated with member states and the European Parliament.

Funds for innovation, modernisation, and reducing dependence on imported fossil fuels

On top of the 400 billion euros channelled to member states and the bloc's budget, the sale of allowances will raise funds for dedicated programmes.

The Innovation Fund, the EU's largest funding program for the deployment of innovative, low-carbon technologies and processes in energy and industrial sectors, and net-zero mobility solutions in maritime, aviation, and road transport, is forecast to generate around 40-43 billion euros between 2020 and 2030.

The Fund is filled up with allowances from multiple sources, including the auctioning share, the free allocation share, unallocated allowances from the MSR, and others. How much money the Fund will raise depends not only on allowance pricing but also on the volume of allowances ultimately received from sources such as the phase-out of free allocation to Carbon Border Adjustment Mechanism (CBAM) sectors, reduction of free allocation due to conditionality rules, and leftover allowances not issued to aircraft operators. These volumes are currently unknown but will be confirmed in the years ahead.

The Modernisation Fund, which supports low-carbon transitions in 10 lower-income member states, was initially filled allowances representing 2% of the total ETS cap for the years 2021-2030. Under the EU ETS reform, the Modernisation Fund will benefit from an additional 2.5% of the cap in 2024-2030. This sum is complemented by the voluntary transfer of allowances received by lower-income EU states from other sources, including so-called solidarity allowances. In total, this Fund is expected to reach approximately 56 billion euros and will sell around 750 million of its allowances by 2030.

Additionally, the REPowerEU program, established to reduce EU dependency on fossil fuels, will be filled in with EU ETS allowances. Their sale will provide 20 billion euros for projects diversifying EU energy supplies. These allowances will come from the share of allowances that would otherwise be auctioned and from the Innovation Fund.

The biggest of all funds, the Social Climate Fund, will provide up to 65 billion euros of EU funding to address the effects of ETS 2 on vulnerable households, transport users, and micro-enterprises. This Fund for energy transition in the building and transport sectors will be funded from the auctioning of ETS 2 allowances. It will support investments in enhanced energy efficiency for buildings and zero- and low-emission mobility and transport, with member states co-financing 25% of the total estimated cost of social plans.

Contribution of CBAM

Furthermore, additional revenues will be generated by the EU's newly instituted Carbon Border Adjustment Mechanism (CBAM), which will impose a carbon levy on goods imported from jurisdictions that lack carbon pricing systems. The sale of CBAM certificates will likely provide more than 9 billion euros during the years 2027-2030 (in current prices), if no third countries receive exemptions from CBAM. The Commission proposed that, from 2028 onward, 75% of the revenues from selling CBAM certificates will be directed to the EU budget.

EU ETS label

With auction proceeds increasing and additional revenues from the sale of CBAM certificates, it is critical that these funds support further mitigation, especially in sectors covered by emissions trading. Revenues from EU ETS could boost investment capacity, generating much-needed funds for the low-carbon transition. The recent EU ETS reform also introduced an "ETS label," which will have to be displayed for projects and activities supported by EU ETS funding. IETA hopes it will soon become an indispensable element of the EU's investment landscape.

(Julia Michalak, EU policy director at the International Emissions Trading Association)

Complaints Procedure

Produced by Thomson Reuters Accelus Regulatory Intelligence 14-Jul-2023