



EU CARBON MARKET REFORM

SPECIAL REPORT | JULY 2021

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The EU's Emissions Trading Scheme (EU ETS) is often presented as the crown jewel of EU climate policy, putting a price on carbon emissions from the power sector and industry. With a major reform process now underway, EURACTIV looks at the implications from a social and economic point of view.





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INTERVIEW

Analyst: EU carbon price on track to reach €90 by 2030

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By Frédéric Simon | EURACTIV.com



ICIS expects a new wave of renewable energy investments in the coming years, driven by the high price of carbon and electricity, which are making renewables more profitable for investors. [dragancfm / Shutterstock]

High gas prices, combined with a recent decision to raise the EU's climate goals for 2030, have combined to form a “perfect storm” on the EU carbon market, according to a market analyst who predicts a carbon price of €90 per tonne by the end of the decade.

Florian Rothenberg is an analyst on EU power and carbon markets at ICIS, an independent commodity intelligence services firm. He spoke to EURACTIV's energy and environment editor, Frédéric Simon.

INTERVIEW HIGHLIGHTS:

- Current high carbon prices on the EU ETS are driven by: 1) the 2018 ETS reform; 2) high gas prices, and; 3) expectations of a tighter supply of CO₂ allowances until 2030.
- High gas prices have triggered a switch back to coal generation.
- New players have entered the EU carbon market, driving speculation and increasing market volatility, a trend that is expected to continue in the coming years.
- By 2030, ICIS estimates carbon prices on the EU ETS will hit €90 per tonne and electricity firms have built reserves of CO₂ allowances in anticipation of a tighter market.
- Poland and Spain have highlighted concerns about carbon prices escalating too quickly, an issue that is likely to come up again in the political debate on the reform the EU emissions trading scheme.
- The reformed EU ETS will need to bridge the gap between EU countries like France, which already have a low-carbon electricity mix, and poorer coal-reliant countries like Poland. A redistribution of ETS revenues

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- will be needed to bridge that gap.
- ICIS expects a new wave of renewable energy investments in the coming years, driven by the high price of carbon and electricity, which are making renewables more profitable for investors.
 - For energy-intensive industries, the green transition will take longer because of continued allocation of free ETS allowances and higher CO₂ abatement costs. Decarbonisation there requires a higher carbon price as well as protection from carbon leakage.

The carbon price on the ETS reached €50 per tonne for the first time this year, and even got close to €60 at the beginning of July. What caused this market rally in your view? Is it the latest reform of the ETS that was decided in 2018 or was it fuelled by speculation about the next reform and a tighter emissions cap for 2030?

It's a combination of factors. We have indeed seen already a big reform of the ETS in 2018, which introduced the market stability reserve (MSR). Before that, carbon prices were hovering around €5 per tonne and the belief in the EU's determination to go forward with the carbon market was quite low.

The 2018 reform dealt with this historic oversupply of allowances on the market. And our expectation for quite a long time was that the years 2021, 22 and 23 would be extremely tight in terms of supply of carbon allowances because the MSR would withdraw around 300 million allowances annually during that period. And the auction supply that comes to the market is actually not enough to meet the demand of power producers for example. As a result, the market is crowding out the

oversupply that is there.

Now, although this rally in carbon prices is in line with our expectation, we weren't expecting it to reach such levels that fast. In our view, other important factors were at play. One was definitely when the European Commission confirmed its ambition to stay the course on climate policy and reduce the EU's emission by at least 55% by 2030, even after the COVID pandemic hit Europe,

Before the pandemic, the Commission was talking about a 50-55% target, now is "at least 55%." That was really an important element in the past 6-12 months, which has attracted new players in the market.

And in addition to that, we still are in a market, which is mainly driven by power producers. And especially high gas prices have been extremely important in the last six months as a driver of the carbon price.

While gas prices in 2019 and 2020 were quite low, there were high levels of fuel switching, with a lot of gas replacing coal power production. This year, the winter has been extremely long, we see low gas storage across Europe and extremely high gas prices as a result. And that has basically triggered a switch back to coal generation, which means that power producers had to purchase EUAs again to cover the emissions from their coal power units.

So, we have on the one hand this long-term element, which is the prospect of a really tight EUA market towards 2030. Then on the other hand you have the general fundamental tightness on the market triggered by the market stability reserve. And then the last element, which is more short term, you had the gas market. After

all we have seen kind of a perfect storm for such high prices.

What hedging strategies have market players adopted to deal with the higher carbon prices on the ETS? Do you believe some market players may be hoarding on their emission allowances in anticipation of a tighter market in the coming years?

We have seen some large power producers already in 2018 starting to build up reserves. For example, RWE announced that they were financially hedged until 2030 to cover their lignite and coal power plants against any fluctuation in carbon prices. In other words, they are holding some kind of reserve of allowances as a financial hedge to secure against rising carbon prices in the coming years.

And we have seen that with other power producers as well – they have been active in the market for quite a long time and understand quite well how the system works.

What's interesting is that they don't only hedge, they are also active players in the market in terms of trading. For instance, we saw a big interest in 2019 when the EU made clear it was preparing to raise its greenhouse gas reduction target. And because these players are planning for the long term, they already kind of knew what's coming, and built up significant positions in preparation for that.

All in all, that helps the market to find a price which helps Europe to decarbonise until 2030. The European Commission reckons the price of CO₂ in 2030 could be around €85 per tonne, some studies say €120. We would argue that it will be probably in between, with our initial

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modelling indicating a range slightly above 85€/t CO₂ by 2030

Coming back to what you said about electricity companies buying allowances in anticipation of a tighter market. You could call that hoarding, in a way. Has that contributed to creating a shortage of allowances, which has pushed prices up?

There are two elements. Hoarding can be an issue of course if it concentrates power into the hands of a single player. But what we have seen is that there are quite a lot of players active in the market. And if all players hoard a bit, then it balances out in the end.

Speculators buy allowances because they think they are undervalued in the future. And we have seen a growing number of players on the market. If the price now rises, it also means that they can liquidate when they see a chance to make a profit, for example when prices rise too fast.

So you think there's enough liquidity on the market?

Yes. The proposal by the European Commission allows a liquidity of around 833 million allowances in the market. The rest is put into the market stability reserve gradually.

That means even in a cold winter there is always enough allowances to balance the market and for market participants to hedge their price exposure. In the past we have mainly seen that from power producers but their hedge books will rather decline as the sector decarbonises at fast pace so even if the industry starts hedging more actively there should

be sufficient liquidity.

The current ETS was characterised by over-allocation of allowances, which kept prices below €10 for many years. Now, with more sectors joining like maritime and aviation, some are worried about a potential shortage of allowances. Do you see a risk of shortage as well?

Maritime transport is one element, it will be directly added to the current ETS, and it will definitely put more burden on the other sectors.

Shipping has high abatement costs, the technologies there are not as mature as in the power sector, where PV and wind have become super cheap, and are a great source of abatement.

Now, is there a risk of the market becoming too tight because of shipping? I don't think that this will be the case, because the price signal will ensure that the market is not too tight.

And if the price escalates too quickly, there are still safety mechanisms in place. If for example, the number of allowances in circulation drops below 400 million, you will get supply back to the market via the market stability reserve, which can release 100 million allowances. This also happens when prices rise to quickly in a short period of time.

This is a topic, which has not attracted much attention yet in the proposal, but we have seen some member states like Poland and Spain that have highlighted their concerns already. So we could see proposals to see these mechanism further strengthened.

What do you believe will be the effect on the carbon price of including road transport and buildings in a new separate ETS?

As this is a separate ETS, we don't see a direct impact on the EU ETS price, because there is no bilateral validity of the allowances.

However, we have analysed is that the abatement costs in these sectors at the moment are significantly higher, even above €200 per tonne in some countries. This often has to do with the fact that consumer electricity is much more expensive than gas or oil for heating and transport in many countries.

That said, these high abatement costs will decline in the future. And in the Commission proposal, they start phasing in the system as of 2026, by which time electric vehicles and heat pumps will probably be much cheaper.

So I think there are really good chances that the prices in the separate ETS will not reach €200 in the year 2026.

Are you suggesting that carbon prices on the new ETS might reach €200 in 2026?

Not as soon as 2026, no. However, based on current abatement costs, we have analysed that the price by 2030 would probably have to be as high as €200-€250 per tonne in order to trigger some real decarbonisation in those sectors.

But since the system starts a bit later, that gives time to deploy infrastructure for electric mobility and for the renovation of buildings.

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And there is a chance that the price in 2026 won't have to be that high.

At the same time, there will be a frontloading of auctions so we won't expect a super short market immediately. You will likely have a bit of oversupply in the beginning to help market participants to form a price that will then trigger the necessary abatement.

Back to the main EU ETS: with its reform plan, the European Commission said it anticipates a carbon price of around €85 per tonne by 2030, while others anticipate a carbon price of around €100. This is fundamentally different from the current price, which only recently went above €50. What would be the effect of a carbon price of €100 on the EU's economy?

I think I have to clarify first that ICIS does not believe that the price will reach €100 this year or next.

Industries still receive quite some free allocations this year. Of course it's a little harder for the power sector to save emissions via fuel switching this year, but overall we still have an oversupply in the market.

We have to see also the political risk if prices reach, let's say, €90-€100 this year. If prices escalate even further there certainly will be proposals from MEPs to limit speculation. And the market usually reacts quite quickly to these kinds of proposals.

So what we expect is a more steady price increase over the years, with some fluctuations of course, reaching €90 towards 2030.

And, in your view, what are the broader

economic consequences of carbon prices reaching close to €100 per tonne by the end of the decade? Will this trigger a real acceleration in the energy transition in the power sector?

Yes, we do expect an acceleration. We have seen already market-driven renewables kicking off thanks to the carbon price and corporate power purchase agreements. If you look at power prices for the coming year, you see prices reaching towards €90 per megawatt hour in Germany, for example. And at the same time, you have a levelised cost of electricity for PV at around €40-€45.

So I think in the years ahead, renewables will be really profitable for investors. And I think that will really kick off in the next years, especially with the high power prices that we have at the moment.

Of course power prices will decline a bit with gas prices retreating. But what those high power and carbon prices show is that we need more renewable investments. Of course it always takes some time until it really kicks off. But for the power sector, that should really drive a wave of investments in renewable assets. And I think the updated renewable energy directive is something that will help steer that a bit more.

There's no more need for subsidy in many places, so it will be just driven by the carbon price and by the market price for power.

And what about energy intensive industries: steel, cement, chemicals, etc.?

For industry, I think it's harder. It takes them more time to react than

the power sector because they are less active in carbon trading, they have a bit of visibility for a couple of years ahead thanks to the free allowances they get. Smaller players in particular haven't been really active in the ETS for a long time, they often purchase allowances at the last minute, ahead of compliance deadlines.

That won't work anymore in the next years, they will have to change their buying strategy, especially if free allocations decline. And at the same time, they also have to start thinking about the abatement options for their respective units.

But you can see they are also starting to prepare. We are starting to see big projects for green hydrogen steel here and there. These are only small examples right now, but we expect to see a growing number of projects like this in the next years. And if that does not happen in the next years, I would expect the carbon price to increase further until that happens.

And in terms of abatement costs, we see some of these projects already becoming viable with a carbon price of €50-€60.

Some countries in Europe face a bigger challenge than others when it comes to decarbonisation - notably Poland, which still gets almost 80% of its electricity from coal. Will a higher carbon price help bridge that gap or do you believe it will make those divergences even bigger?

On the one hand, we see growing convergence of power prices in Europe, which is good because everyone pays the same. In France, for instance, you see power prices often

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driven by coal in Germany.

And then you have countries like Poland, which are heavily coal reliant. They will have higher power prices on average than countries like France, which have an already extremely low carbon power system.

That's why the ETS will have to make a bridge on where the revenue goes. Poland, for example, has made clear already a couple of months ago that they want more revenues from the ETS in order to help the transition of their energy system. And with a bigger EU modernisation fund under the reformed ETS, Poland will benefit directly.

I think that will be something extremely important in the debate, because as long as fossil-reliant member states get enough revenues from the ETS, they will be able to make those investments and bridge that gap.

Can the EU modernisation fund ever be big enough to satisfy Poland?

Some countries are quite decarbonised, and they will have to relinquish some of their revenues from ETS auctions if they want other countries to get on board. That's the trade-off. It's a European system, and you have to decide what country gets how much of the pot, basically. You have to make sure that there is a fair treatment.

Turning to industries like aluminium, which are big consumers of electricity – should they prepare for higher electricity prices as a consequence of a tighter ETS?

There are two elements to this. On the one hand, you have increasing

volumes of renewables, which tend to lower electricity prices. And at the same time, you have rising carbon prices, which push up the power price when renewables aren't producing.

This means you get bigger peaks and troughs in prices, which will eventually provide a business case for electricity storage in the coming years. This year is quite special, because we had a cold winter and extremely high gas prices. We expect electricity prices to remain high in the next years, also driven by carbon, that could trigger a wave of renewable investments.

As more renewable electricity is added to the power system, power prices should go down again and remain flat on average. So overall, our expectation is that power prices will be rather stable in the coming years.

Energy intensive industries like steel and cement have already complained about the ETS pushing up electricity prices and undermining their competitiveness. Could higher carbon prices on the ETS be the final nail in the coffin for those industries?

A carbon leakage protection is really important to address this issue. Until now, those industries have received a lot of free allocations from the ETS to alleviate competitiveness concerns. Now, some of them will be covered by the new Carbon Border Adjustment Mechanism (CBAM).

And the political process to get this approved will be really hard, because the Commission is facing pressure internally from the industry and externally from potentially affected countries, which have already expressed concerns.

It will be a big challenge, but I think the industry generally wants a carbon border adjustment and they also want free allocations at the same time. The Commission proposal is a compromise with a gradual phase-out of free allocation, which according to their lawyers should be compatible with WTO rules. The affected companies will therefore be able to adjust gradually to the full price exposure. And companies which produce low carbon steel, they will benefit from that.

It has to be a carefully designed instrument so that there are no windfall profits and that allocations are only distributed to companies which are exposed to the risk of carbon leakage.

Some of those industries have made the point that European manufacturers will be exposed to the EU carbon price for 100% of their production, whereas foreign producers will be exposed to CBAM only for the part of their production which is exported to the EU. This means European companies will still be at a comparative disadvantage...

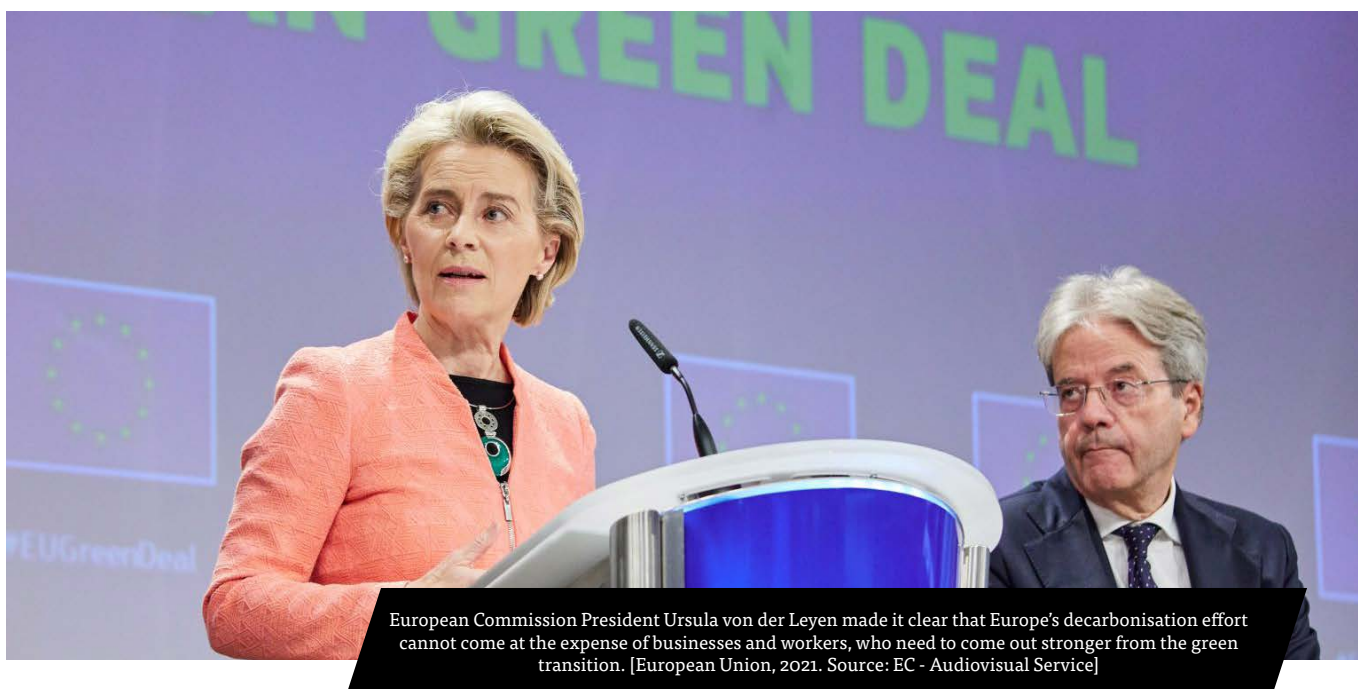
It's a valid argument, which is important to highlight. But there are ways of addressing this, for example by applying an average carbon intensity to the entire production of the foreign company. This is something that is likely to come out in the debate when CBAM gets discussed in the EU legislative process and a solution will need to be found.

There is a similar debate about export rebates, which energy intensive industries are also asking for. But the CBAM is a separate file, it will take time until it is implemented, and a lot can change in the meantime.

Carbon market overhaul shifts EU's climate policy focus on industry, fairness

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By *Frédéric Simon* | EURACTIV.com



European Commission President Ursula von der Leyen made it clear that Europe's decarbonisation effort cannot come at the expense of businesses and workers, who need to come out stronger from the green transition. [European Union, 2021. Source: EC - Audiovisual Service]

With its proposed reform of the EU Emissions Trading Scheme (EU ETS), the European Commission is bringing carbon pricing policies to new areas such as shipping, road transport, and buildings. However, it is the fate of industry and ordinary people that is getting all the political attention.

The EU ETS currently covers the power sector, the manufacturing industry, and intra-EU flights.

With the reform, the Commission proposes to extend the EU carbon

market to shipping and aviation while setting up a new separate ETS to tackle emissions from transport and heating fuels.

The aim is to cut the EU's carbon emissions by 55% before the end of the decade and bring clean energy to areas like transport, buildings and industry, where fossil fuels still dominate and emissions reductions are more costly to achieve.

But European Commission President Ursula von der Leyen also made it clear: Decarbonisation

efforts cannot come at the expense of businesses and workers, who need to come out stronger from the green transition.

"The European Green Deal is our growth strategy," von der Leyen insisted when presenting the EU's new 'Fit for 55' package of climate policy proposals on Wednesday (14 July).

And fairness will be one of the key priorities when extending carbon pricing policies to new areas, with the creation of a new social climate fund to shield the poorest households from

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higher fuel prices.

Over the 2025-2032 period, the new fund is expected to mobilise €72.2 billion in fresh money, providing direct income support for vulnerable households impacted by the change, and supporting investments into clean heating and mobility.

“If you look at transformations in Europe, every transformation, we were successful when we combined market-driven measures with the right social balance,” von der Leyen said. “This is at the core of our social market economy”.

MORE FUNDING UNDER THE REFORMED ETS

In the reformed ETS, this means more funding will be channelled to the EU’s innovation and modernisation funds, which will roughly double in size.

“We are not going to let our industry down. And we’re not going to make policies to de-industrialise the EU, it would make no sense from an economic and environmental point of view,” said a senior EU official who briefed journalists before the Commission’s ‘Fit for 55’ package was presented.

The innovation fund, which supports first-time innovators in developing low-carbon technologies, will be almost doubled in size with a firepower of more than €50 billion at current ETS prices over ten years, the official explained.

At the same time, the European Commission will more than double the modernisation fund, meant to help poorer EU member states invest in clean energy.

The move is meant to assuage concerns of countries like Poland, which is still reliant on coal for close to 80% of its electricity and faces higher decarbonisation costs than other member states.

However, the proposed reform will not bring the money necessary for the transformation, according to the Polish electricity industry, which estimates that new investments worth €136 billion will be needed by 2030 in Poland to reach the EU’s clean energy goals.

“This amount exceeds four-fold the total amount of currently available national and EU funds for the decarbonisation of the Polish economy, and thus additional financial support will be needed,” said PKEE, the Polish electricity sector association.

“We believe that the Modernisation Fund should be increased significantly,” it said in a statement.

Another concern for Poles is the restrictions the Commission has placed on the modernisation fund, which prohibits investments in natural gas. According to PKEE, gas power plants and cogeneration units in district heating systems are “the only solution to progressively withdraw coal-fuelled units and switch to less emitting gas as an intermediate fuel on the way to carbon neutrality”.

A FAIRER MARKET?

The demands of the Polish electricity sector illustrate a fundamental shift in the political debate over carbon pricing. With the reform of the EU ETS, much of

the conversation is now expected to focus on how the effort should be distributed between EU member states and across industries.

As Europe tightens the cap on emissions, EU carbon prices are expected to reach €85 per tonne towards the end of the decade, according to the European Commission. Others believe the price could even reach €120 by then.

“A carbon price towards €100 per tonne by 2030 is pretty much in line with our own forecasts,” said Hæge Fjellheim, director of carbon research at Refinitiv, a carbon market data analysis firm.

And at those kinds of prices, solidarity with poorer households but also between EU member states will become central to the political debate, she told EURACTIV in a telephone interview.

“With a higher carbon price, you also get more revenues to help decarbonise the economy. Who should be the recipients of those funds is going to be one of the key subjects of discussion in the next few years,” Fjellheim said.

DISTRIBUTION KEY

Poland is positioning itself at the forefront of this debate.

In a statement, PKEE said the ETS reform is “an excellent opportunity to seek a more accurate allocation key to ensure that low-income countries have sufficient revenues in their national budgets to cope with energy transition”.

Currently, 2% of revenues generated by ETS auctions across

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all 27 EU member states are being fed back to the EU modernisation fund, where they are redistributed to the 11 poorest EU member states to help modernise their energy sector. Under the proposed new system, the percentage will more than double and reach 4.5%, according to the EU executive.

But there are discussions on how this money should be used in the future, with the European Commission proposing to ban investments in gas.

According to Fjellheim, this topic is likely to be “quite prominent” in the upcoming political discussions between EU member states and the European Parliament, because most of the auction revenue is currently going to national governments, who can essentially use the money as they please.

“These auction revenues are currently what helps national governments finance policies to decarbonise their economies and to cope with higher carbon prices. So any proposed changes in the distribution key is likely to be a matter of intense debate,” Fjellheim said.

Florian Rothenberg, another carbon market analyst, agreed, saying a higher carbon price is in the interest of Poland, which will benefit directly from a bigger modernisation fund.

“As long as fossil-reliant member states get enough revenues from the ETS, they will be able to make those investments and bridge that gap” with wealthier EU countries, said Rothenberg, who is a carbon market analyst at ICIS, a global commodity intelligence service firm.

However, he predicted tough

discussions ahead on how the auction revenues will be shared among EU member states.

“Some countries are quite decarbonised and they will have to relinquish some of their revenues from ETS auctions if they want other countries to get on board,” Rothenberg said.

“That’s the trade-off. It’s a European system, and you have to decide what country gets how much of the pot, basically. You have to make sure that there is a fair treatment.”

But high carbon prices also have negative consequences in the short term because they inflate costs for the power sector and industry, which need to pay a higher price for EU emission permits.

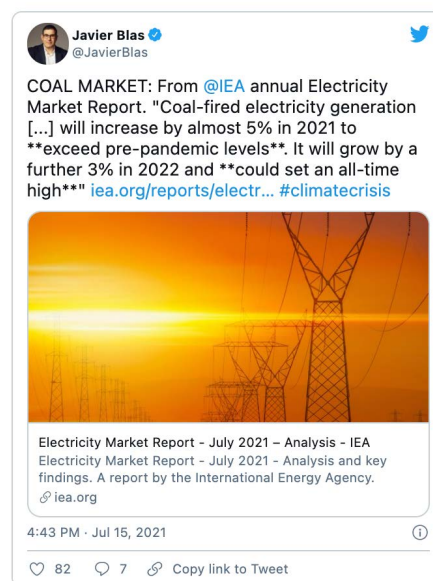
When gas prices were still low in the 2019-2020, there were high levels of fuel switching, with gas power plants replacing coal units, Rothenberg explained. But this year, the winter was longer and colder than usual, which depleted reserves across Europe, pushing up gas prices as a result.

“And that has basically triggered a switch back to coal generation,” which became cheaper than gas as a result, Rothenberg said, a trend that was reported recently by the International Energy Agency.

[See the following image]

DISTRIBUTION KEY

So could carbon prices be too high? Again, Poland is first in line to warn about such a risk, with the country’s climate and environment minister, Michał Kurtyka, raising “concerns over the potential speculative nature



of the volatility”, which he said could undermine the carbon market’s ability to deliver on the EU’s climate objectives.

Although Warsaw does not oppose high carbon prices in principle, the short-term negative effects on the economy “can lead to cost pass-through and hindering the green transformation,” especially during the recession caused by the COVID-19 pandemic, [he wrote in April](#), when prices were getting close to €50 per tonne.

Kurtyka did not say whether Poland would support a carbon price ceiling, but EURACTIV understands that Warsaw supports the idea, provided the ceiling is not too high.

The discussion over carbon price “corridors” – with a maximum and a minimum – to prevent speculation on the market is not new. However, it has tended until now to focus on introducing a price floor in order to deal with depressed prices on the EU ETS, not a ceiling.

According to Rothenberg, a price ceiling may not be necessary because

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there are already safety mechanisms in place to prevent the carbon price from escalating too quickly.

“If for example, the number of allowances in circulation drops below 400 million, you will get supply back to the market via the market stability reserve, which can release 100 million allowances. This also happens when prices rise to quickly in a short period of time,” he explained.

However, he does expect that the issue of high carbon prices will come up again in the political debate. “We have seen some member states like Poland and Spain that have highlighted their concerns already. So we could see proposals to see these mechanism further strengthened.”

POWER SECTOR LOW-HANGING FRUIT ‘GONE’

In the longer term though, higher carbon prices are welcome by most because they accelerate investments in renewable energy.

Market interest in renewables was already noticeable in the past years, despite a relatively modest carbon price of around €20 per tonne, Rothenberg says. Now, with prices firmly above €50, he expects an acceleration in the clean energy transition.

“In the years ahead, renewables will be really profitable for investors. And I think that will really kick off in the next years, especially with the high power prices that we have at the moment,” Rothenberg said. “There’s no more need for subsidy in many places so it will be just driven by the carbon price and by the market price for power.”

Perhaps a bigger concern is the impact that a tighter carbon market will have on industry.

Until now, the most visible effect of the EU ETS has been to trigger fuel switching from coal to gas and renewables. But getting emissions reductions beyond the power sector will be the hardest part, and a different ball game altogether, said Hæge Fjellheim from Refinitiv.

“Much has been achieved thanks to higher carbon prices inducing fuel switching from coal to natural gas, which is the low-hanging fruit,” Fjellheim said. In other terms, “the abatement potential in the power sector will diminish over this decade,” she predicted.

TURNING UP THE HEAT ON INDUSTRY

And with the electricity sector cleaning up its act, attention is shifting to industries like steel, cement, and chemicals, where emissions reductions are more costly.

“A lot of the burden will be on energy-intensive industries, because the low-hanging fruit in the electricity sector is already gone,” Fjellheim said. “With the focus shifting to industry, emission reductions are going to be more difficult to achieve. This is why you need a strong price signal of up to €100 per tonne,” she said.

According to Rothenberg, Europe’s industry has been relatively spared from high carbon prices until now because they received most of their CO₂ allocations for free. Smaller industry players in particular have not been very active in the ETS and often purchase allowances at the last minute, just ahead of compliance

deadlines, he remarked.

“That won’t work anymore in the next years, they will have to change their buying strategy, especially if free allocations decline,” he said.

Some have already started to prepare. In Sweden, a start-up called [H2 Green Steel](#), is on its way to launching the world’s first large steel production plant powered by green hydrogen in the northern part of the country. A Swedish test plant, called ‘Hybrit’, [already uses green hydrogen produced exclusively in Sweden](#).

And in Germany, the government has made €5 million available to the Salzgitter AG group to produce climate-friendly steel as part of a wider industrial decarbonisation project.

Still, CO₂ abatement costs in those sectors remain prohibitively high at the moment, meaning they require a higher carbon cost to be profitable.

“We are starting to see big projects for green hydrogen steel here and there,” Rothenberg said, adding some of those projects are already becoming viable with a carbon price of €50-€60.

“These are only small examples right now, but we expect to see a growing number of projects like this in the next years. And if that does not happen in the next years, I would expect the carbon price to increase further until that happens.”

To bridge the price gap, the European Commission is proposing to introduce so-called carbon contracts for difference (CCfD), which allow EU countries to provide state aid to firms making investments in clean technologies. Governments pay out

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the difference between the price of emissions allowances (EUAs) on the carbon market and a pre-agreed CO₂ contract price, thereby ensuring a guaranteed carbon price for clean energy projects.

According to the Commission, “the size and scope” of the innovation fund will be extended to support such government-funded projects using CCfDs.

The idea was pushed by Germany and welcomed by Peter Liese, a senior German EU lawmaker from the centre-right European People’s Party (EPP) and a key ally of Commission President von der Leyen in the European Parliament.

For instance, companies that invest in green steel production will also be offered free allocations under the ETS in order to encourage them to invest, Liese explained. “They can get free allowances for five more years. So you can get a lot of cash from the ETS,” he said.

“We want to decarbonise industry, not de-industrialise Europe,” Liese insisted. “This is very important for the EPP”.

CARBON BORDER ADJUSTMENT MECHANISM (CBAM)

There are other incentives for industry in the EU’s ‘Fit for 55’ package.

The most controversial is a proposal to put a carbon price on goods imported in the EU, the so-called carbon border adjustment mechanism (CBAM).

The levy will apply gradually to

six sectors, which already benefit from free allocations under the ETS: electricity, iron and steel, aluminium, fertilisers, and cement. Those will be phased out completely by 2036, leaving these sectors time to adjust.

According to the European Commission, the move “will ensure that our climate ambition is not undermined by foreign firms subject to more lax environmental requirements” while encouraging foreign countries to decarbonise as well.

The move has already stoked fears among emerging countries like China, which raised “grave concerns” about the carbon levy creating new barriers to trade.

And in Europe, some are worried the EU carbon border levy could trigger a trade war.

“It is already clear that many would regard the existence of free allocation alongside the levy as a ‘double protection’ providing them with a rationale for retaliation,” warned Connie Hedegaard, a former EU climate commissioner, and Pascal Lamy, former World Trade Organisation director-general.

“That such tensions could persist and ultimately lead to a trade war would not only damage the EU’s climate leadership” and risk sinking international climate negotiations, the pair wrote in an opinion piece for EURACTIV.

However, carbon market analysts believe some form of border protection will be needed in Europe in order to make enough space for industry to decarbonise.

“The Green Deal is not only about reaching a climate target, it’s also about Europe coming out of the process with a stronger, greener economy,” Fjellheim says. “The whole ‘Fit for 55’ package is also much about helping industries green their operations and inciting other countries to step up their climate action,” she explained.

According to Fjellheim, the Commission’s proposal to gradually phase-out free ETS allowances over a ten-year period was probably a carefully balanced decision. “The Commission has chosen a cautious approach, probably both to ensure backing from European industry and policymakers and to avoid stirring up international partners,” she said.

Rothenberg agreed, calling the Commission proposal a compromise that seeks to balance the interests of Europe’s industry with trade concerns.

However, he predicted that “the political process to get this approved will be really hard, because the Commission is facing pressure internally from the industry and externally from potentially affected countries”.

“It has to be a carefully designed instrument so that there are no windfall profits and that allocations are only distributed to companies which are exposed to the risk of carbon leakage,” Rothenberg said.

EU industry shuns carbon border levy, calls for export rebates

By Nikolaus J. Kurmayer | EURACTIV.com



As industry's most favoured shield from carbon prices in the EU is set to expire as the bloc's carbon border levy is phased in, it now eyes additional support in exporting. c Shutterstock/ ABCDstock

European industries covered by the EU's future carbon border adjustment mechanism (CBAM) have expressed doubts about the proposal, tabled last week. In addition to border measures, they are calling for an export rebate scheme to help green EU products compete on global markets.

The European Commission tabled proposals last week to introduce a carbon levy at the EU's borders in order to protect EU manufacturers from cheaper imports of carbon-intensive

goods coming from abroad.

The new scheme "will ensure that our climate ambition is not undermined by foreign firms subject to more lax environmental requirements" while encouraging foreign countries to decarbonise as well, the Commission said.

The levy will apply to six categories of imports: electricity, iron and steel, aluminium, fertilisers, and cement. The system will be phased in as of 2026 for a period of ten years, by which time

EU industries covered by the scheme will stop receiving free CO₂ permits on the EU carbon market, a move aimed at ensuring the system is compatible with World Trade Organisation rules.

The EU's proposed carbon border adjustment mechanism – or CBAM – is [feared by Australia](#), and [raised "grave concern"](#) among emerging economies such as Brazil and China which see the proposal as protectionist.

But European industries covered by the proposal aren't fans of it either.

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“All metals sectors have expressed concerns that the CBAM as designed would disadvantage Europe producers irrespective of their carbon footprint,” said Eurofer, the European steel industry association, following the announcement of the Commission’s proposal.

Industry is worried that the gradual introduction of the levy will coincide with a phase-out of free CO₂ permits they receive under the EU’s emissions trading scheme (ETS).

Free ETS permits are the favoured option of European industrialists because they apply to their entire production while CBAM, by contrast, applies only to imports.

“ETS free allowances and CBAM are not alternatives,” said Ines Van Lierde, chair of AEGIS Europe, an industry coalition, which brings together almost all the industries covered by the Commission’s CBAM proposal.

AEGIS is spearheading efforts by European industry to obtain more support from the EU as the age of free ETS allocations slowly comes to an end.

While European industry has been subject to a price on carbon emissions since 2005, they have been largely insulated from ETS price increases thanks to a generous free allocation scheme. But now that carbon prices are reaching record highs of more than €50 per ton, they are worried about the additional cost the ETS will represent.

“A lot of the burden will be on energy-intensive industries, because the low-hanging fruit in the electricity sector is already gone,” said Hæge Fjellheim, director of carbon research

at Refinitiv, a carbon market data analysis firm.

“With the focus shifting to industry, emission reductions are going to be more difficult to achieve. This is why you need a strong price signal of up to €100 per tonne,” she told EURACTIV.

EXPORT REBATES

With the end of free ETS credits, industry will have less money available to invest in low-carbon technologies, European manufacturers warn. And while CBAM will ensure competitive parity with foreign producers, the Commission’s proposal does not foresee any replacement for the external trade dimension, they say.

“The proposed phase-out of free allocation and the absence of export rebates would cause significant risks to investment,” said Koen Coppenhelle, chief of Cembureau, the European cement industry association.

In order to maintain their competitiveness against Chinese imports, European industry is asking for what would effectively amount to export subsidies.

“These export adjustments, they should be granted to products which are produced in the EU and exported to some countries which do not have the equivalent carbon limitation or pricing policies,” says Hervé Jouanjean, a former EU official who was director for WTO affairs at the European Commission.

Although export rebates are currently not part of the EU’s climate and trade policy arsenal, he says it can be compatible with WTO rules.

“Properly designed as we propose, they do not constitute export subsidies under WTO rules,” said Jouanjean, who is now senior trade expert at law firm King & Spalding, and spoke on behalf of AEGIS Europe.

Overall, AEGIS Europe defends a combination of free ETS allocations, a carbon border levy, and export rebates, saying they are distinct elements of an integrated EU policy dealing with different aspects of trade and climate.

“We see absolutely no problem with the WTO legitimacy of a carbon export adjustment which is part of a carbon reduction policy,” says Bernard O’Connor, a trade lawyer with Italian firm Nctm.

And, according to O’Conner, all three measures “can continue to exist independently as long as they are needed” to ensure a level playing field.

“A level playing field is what we’re looking for,” said Bernard Lombard, trade and industrial policy director at CEPI, the European paper industry association, who is chair of the AEGIS Europe CBAM task force.

“As long as there is a difference in terms of carbon cost and emission reduction between the EU and the rest of the world, I think we need these tools to make sure EU exports do not become uncompetitive due to our higher climate goals,” he said.

HAVING CAKE AND EATING IT

Environmental NGOs are highly sceptical of the export rebate proposal, saying it would be contrary to WTO rules and would undermine the EU’s climate leadership on the

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international stage.

“export rebates would risk creating perverse incentives and would not be coherent with the drive to encourage higher climate ambition globally,” said Agnese Ruggiero from Carbon Market Watch.

“Asking for export rebates on top of free allowances and CBAM is like having the cake, eating it, and reaching over for the muffins too,” she told EURACTIV.

Ruggiero is not alone expressing scepticism about export rebates. When AEGIS Europe consulted with the European Commission’s trade experts about this, they appeared similarly wary.

“Informally, when we raised this with people in the Commission, they said it’s not possible,” O’Connor admitted. “But the way we see it, this can be very much a part of an integrated climate policy,” said O’Connor, who authored a [legal feasibility analysis in favour of export rebates](#).

Contacted by EURACTIV, the European Commission did not immediately respond to a request for comment about export rebates.

However, O’Connor believes not everyone in the EU executive is against the idea. “Are there forces in the European Parliament and in the member states which want to look at this issue? The simple answer is yes.”

According to Jouanjean, European industry is confronted with “dogmatic views” from the European Commission which fears that export rebates will be associated to export

subsidies by the WTO.

“But we say this is a narrow-minded way of looking at things,” Jouanjean said. “It is not a standalone measure. It is part of a global approach. So there is certainly a campaign to be made to persuade policymakers that they have to change their approach”

PROMOTED CONTENT

DISCLAIMER: All opinions in this column reflect the views of the author(s), not of EURACTIV Media network.

How to reconcile the different interests in the “Fit for 55” package?

By *Wojciech Dąbrowski* | PGE



Wojciech Dąbrowski. [PGE]

Though all Member States backed EU's higher target of a net domestic reduction of greenhouse gases emissions by at least 55% until 2030 compared to 1990, recently proposed regulatory solutions may deepen a division between countries, when it comes to the method of implementing new targets.

Wojciech Dąbrowski is the President of the Management Board of the PGE Polska Grupa Energetyczna S.A.

Right now, we can observe a different perspective between the

Western Europe, clearly on its pathway to fully decarbonise the power sector well-before 2030 and does not have to look for alternatives for solid fossil fuels in district heating systems and the Eastern part of the continent, still facing tremendous challenges in power and heating sectors alike. That clash of interests will result in a long-lasting legislative battle to be fought in a few years to come.

However, business decisions on how to adapt to the new climate target made by energy utilities cannot be postponed to the mid-twenties. Otherwise, there will not be enough

time to make a real difference until 2030. Therefore, we need to find a right balance of interest throughout the legislative process regarding the “Fit for 55” package and especially the EU ETS reform to avoid a social disaster.

The costs of the achievement of carbon neutrality by 2050 for Polish households will be enormous. The investments in new generation and energy storage units alone will require Polish households to spend an additional EUR 110 billion if we receive no additional EU funds to complement it. [1]¹ It is the amount of

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lost consumption by households as compared to business as usual. This is because to achieve those targets we need investments and someone has to pay for them.

HOW TO ACHIEVE THE NEW 55% EMISSIONS REDUCTION TARGET?

The new target should be achieved through fair-burden sharing between sectors and between Member States. It should be achieved by ensuring that distributional effects of the costs of this transition are spread among Member States proportionally to the capacity of individual citizens to finance the transition. It is the controversial Commission's choice to put more burden on ETS sectors that is unnecessarily heavy and cannot be justified by the need for the EU to become carbon neutral by 2050.

The Commission's proposal to combine the increased linear reduction factor of 4.2%, so far above today's level of 2.2%, together with an additional one-off cap reduction and further changes to the market stability reserve design parameters would result in rising EU ETS allowances price volatility. With such a steep LRF of 4.2% it means that there will be no EU ETS allowances left in the system by 2040.

If we already have an increased LRF of 4.2% why do we still need to strengthen the MSR to achieve the same objective? Linear reduction factor (LRF) alone is enough to drive down the emissions to the required reduction level. Artificially introducing different thresholds for market stability reserve (MSR) makes

little sense since MSR reform has little impact on the achievement of the reduction targets. On the contrary, maybe the best way is to actually relax these thresholds and let more allowances stay on the market or return into the market given the recent carbon price surge as well as foreseeable market shortage in the future?

WHAT IS NEEDED TO AVOID MULTI-SPEED EUROPE IN TERMS OF CLIMATE AMBITIONS?

Huge investment challenges associated with the implementation of the higher climate ambition are ahead of the European Union. The distributional effects of these increased investments within individual Member States will also require careful examination. The overall effort will be inevitably higher in the ETS sectors due to avoiding the negative social impacts for citizens, namely in buildings and transport sector. Otherwise, protests like yellow vests in France are unpreventable. However, what needs to be also recognised is that the same protests would happen if too much burden was placed on the ETS sectors. For countries still based on coal, where huge societal and economic changes will be needed to implement the new target, it remains a really vital risk. This is why more EU funds are necessary to alleviate this investment effort.

We need to reassure our customers and local communities that there will be enough EU support to make sure that they will never be left behind. This can be done if those funds for

energy transition in Member States with different starting points are sufficiently increased. By acting together in the spirit of solidarity we can achieve EU's objectives of decarbonisation.

WHY DOES IT MATTER FOR ENERGY INDUSTRY?

PGE stands for a decarbonisation at the fastest feasible pace without losing our investment funds on operational expenses associated with the purchase of emission allowances to comply with the EU ETS. Last year we spent about EUR 1.8 billion on allowances alone, generating almost 10% of the revenues at the EU ETS market. This translates directly to limiting our capabilities for new sustainable and green investments, since we need to cover the carbon costs in the first place. Even in the light of these operational costs, we cannot simply shut down our conventional plants due to security of supply reasons in order to avoid truly critical situations.

The higher CO₂ price can only drain our funds and capacities to invest in low- and zero-emission energy sources in the future but it cannot speed up our investment plans even further as they are already very ambitious. PGE Group intends to build 2.5 GW of new capacities in offshore wind farms, 3 GW in photovoltaics and expand the portfolio of onshore wind farms by at least 1 GW by 2030.

Today's prices are already enough to make the fuel- switch. This is why we need an effective policy in place to avoid uncontrollable price growth at the end putting intolerable burden on

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our customers.

WHAT IS NEEDED TO FIND AN EQUILIBRIUM?

Among the Member States, Poland has the biggest investment challenge and at the same time the highest imbalance of allowances, meaning that the Polish companies have to buy EU ETS allowances in a number exceeding the Polish auctioning pool and financing budgets of other Member States. It clearly requires a correction so that Poland has enough own resources to finance its own transition. For that reason we believe that the Modernisation Fund should be increased significantly and proportionally to the new climate commitments to respond to these challenges and address the problem of imbalances between Member States accordingly.

We acknowledge the fact that the Commission's proposal intends to increase the Modernisation Fund,

being the consequence of the carbon pricing extension to transport sector and buildings. However, it remains uncertain if the new allocation is proportionate to the new commitments and modernisation cost in energy, industry, transport and residential sectors. We regret that the Commission has not decided to use allowances transferred to the MSR to the Modernisation Fund, otherwise they would be cancelled. This mechanism would not affect national allocation pools of the Member States and in result emission allowances prices.

In our view, to tackle the problem of imbalances is to increase significantly the Modernisation Fund or use MSR allowances. We also ask for maintaining the possibility to finance gas investments under the Fund as a sign of recognition for our specific needs. Deploying natural gas-fired high-efficiency cogeneration plants in district heating systems remain the only viable solution for Poland to

boost withdrawal of coal and switch to less emitting gas as a transitional fuel on the way to carbon neutrality. It would also facilitate improving air quality and limiting the increase in energy poverty.

We believe that only with these measures, we can achieve the balance in the EU ETS and in result a fair and just transition so important for our electricity and heat customers.

Further reading

The PGE Capital Group is Poland's largest energy sector company with respect to sales revenues and net profit providing for a safe and reliable power supply to over 5 million households, businesses and institutions. PGE is actively contributing to the growth of a zero- and low-emission economy in Poland and declared to deliver 50% green electricity by 2030 and 100% green electricity by 2050.

1 https://climatecake.ios.edu.pl/wp-content/uploads/2021/07/POLAND-NET-ZERO-2050.-The-roadmap-toward-achievement-of-the-EU-climate-policy-goals-in-Poland-by-2050.-Summary_FINAL.pdf

CAKE (KOBIZE) Analysis: Poland Net-Zero 2050: It must be emphasised that the energy sector capital costs reported in this study include only investments in new generation units (including those that reserve capacity) and energy storage. They do not include expenditure related to the expansion and modernisation of the transmission and distribution network (both electricity and heating), or the modernisation of existing generation units – so the full investment costs in the energy sector necessary for the implementation of the low-emission transformation will be even higher. In the NEU scenario, the total expenditure in the energy sector in the period 2021-2050 will be at the level of ca. 295 billion EUR. These expenditures are almost 60% higher than in the BAU scenario (ca. 185 billion EUR). Thus the extra expense that will have to be financed by citizens' from their own pockets is 100 billion EUR.



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