

EURACOAL Position Paper on the Commission proposal (COM(2021) 551) to amend the EU Emissions Trading System Directive 2003/87/EU and to adjust the Market Stability Reserve

EURACOAL position

1. The current energy crisis highlights the need for secure, reliable and diverse energy supplies at affordable prices. Coal provides these and so benefits EU society.
2. The long-term phase out of coal should be done in a way that does not harm EU citizens. The coal industry should be adequately compensated, including with social measures for employees, and coal users should be protected from the negative economic impacts of EU climate and energy policy. Support is needed to enable coal companies, large and small, to transition to new activities.
3. The EU emission trading system (ETS) is a market-based system and as such needs to be intelligible, transparent and predictable so that industrial concerns can plan ahead and invest for the future without undue political risk.
4. The proposed “rebasings” of the EU ETS cap and the steeper 4.2% linear reduction factor should be fixed in law, with no further changes allowed at least until 2030.
5. There should be no continuation of the double intake rate of 24% to the market stability reserve (MSR). This was enacted as a temporary measure in March 2018. The regular intake rate of 12% should be restored from 2024, as foreseen in the decision of October 2015 establishing the MSR. At the same time, the MSR should be maintained at the previous years’ volume of allowances surrendered.
6. In anticipation of the return via auctions of allowances from the MSR to the market, the release mechanism should be amended in a similar way to that proposed for the intake mechanism. This would help avoid future market uncertainty on whether or not allowances will be released.
7. The MSR should operate in a way that allows and enables hedging by those market participants who are obliged to surrender allowances each year (*i.e.* compliance entities, rather than non-compliance entities such as speculators). To that end, the number of allowances in circulation (TNAC) should be enough to allow legitimate, long-term hedging by all compliance entities. In addition, EURACOAL members have identified a systemic fault with the MSR that can result in TNAC being actively driven below the threshold set in the EU ETS Directive. The 833 million threshold should therefore be corrected to 1 145 million allowances – this being the average EU ETS Phase 4 annual cap. This would allow all players to use purchased and freely allocated allowances for hedging purposes, but prevent such hedging from starving the market of allowances and artificially driving up allowance prices.
8. Methane emission reduction projects that generate heat and power should be excluded from the EU ETS scope.
9. We support the Commission’s proposal to regulate a new ETS for transport and buildings separately, at least in the medium term. Otherwise, the buildings and transport sectors would be very unlikely to contribute their fair shares of emission reductions.
10. The Commission’s proposed amendments are not based on any impact assessment for the affected sectors. An analysis of the consequences for the economies of individual EU member states is missing. Accordingly, impact assessments are called for before any amendments to the EU ETS Directive are enacted.

11. The proposal to include aviation allowances when determining the total number of allowances in circulation (TNAC) is welcome. However, the TNAC must then be back calculated to when aviation was introduced into the EU ETS in 2013.
12. Likewise, the entire verified emissions of shipping during the gradual phase-in period (2023-2025) must be fully taken into account in the calculation of the TNAC before any allowances are invalidated.

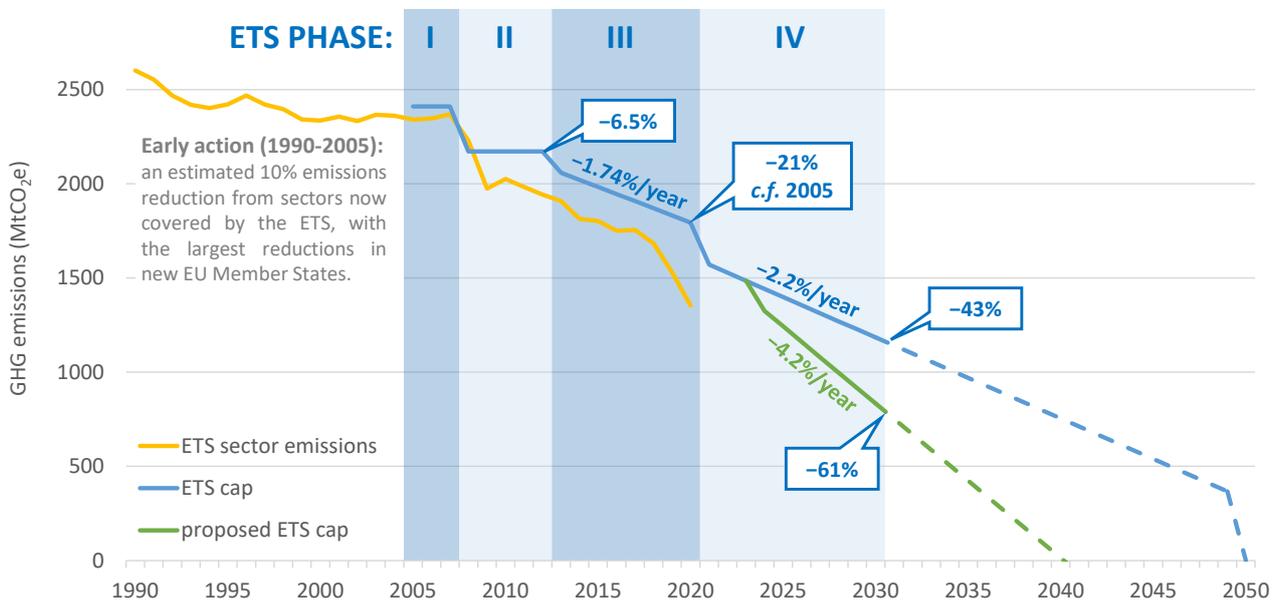
Summary of key points

- The demand for EU ETS allowances (EUAs) for coal fired power plants is anticipated to reduce by 277 million by 2030, but only half of this reduction is assumed overall as coal-fired power plants are expected to be replaced by fossil gas-fired power plants.¹
- The EU ETS sets a common carbon price across the whole of the European Economic Area. Given the widely differing wealth across the region, complementary measures are therefore necessary to alleviate any disproportionate impacts while respecting member states' right to determine their own energy mixes.
- The Commission's detailed modelling work in support of the Fit-for-55 package makes assumptions on EU population and economic growth. GDP is an exogenous input, yet the package is far-reaching and would be a drag on future EU economic growth and industrial competitiveness.
- EURACOAL notes the proposed two-track approach to emissions trading whereby a new separate, but adjacent scheme for buildings and road transport would operate alongside the current EU ETS, with a different carbon price. This is an important step towards decarbonisation of all sectors and underlines the role of the EU ETS as the central element of European climate policy. However, the impact of both systems is disproportionately high on the poorest EU citizens.
- The proposed new ETS for buildings and road transport would add a costly and bureaucratic burden on businesses across the EU, including coal merchants, requiring "elaborate IT developments".²
- The number of entities covered by EU emissions trading systems would rise from around 9 500 to 21 000, including 3 000 coal merchants. In practice, coal and manufactured solid fuels are sold by far more entities, including DIY superstores, so the administrative burden would be much greater than foreseen by the Commission.
- The new ETS is expected to generate significant revenues to help finance investment needs and to address social and distributional impacts arising from the increased fuel prices on low-income households, but it is not clear if these transfers will be sufficient in all member states. ETS auction revenues should be used to mitigate the social impacts of the energy transition, with compensation to those households who cannot afford rising energy prices. Half of the revenues should be used explicitly for this purpose, while the other half should be used for climate and energy related projects.

¹ SWD(2021) 601 part 2, p.77.

² COM(2021) 551, p.5.

Figure 1 – Emission reductions since 1990 and since 2005 under the EU ETS
 The proposed amendments to the EU ETS would rapidly curtail the industrial use of coal.
 Household coal users would be heavily penalised with fuel costs doubling.



Sources: European Environment Agency and COM(2021) 551

Background

The European Commission’s ambition is to make Europe the first climate-neutral continent by 2050. This will require determined EU-level action, as well as action by other European countries. Under the European Climate Law, an EU regulation which came into force at the end of July 2021,³ member states are required to reduce EU greenhouse gas (GHG) emissions by at least 55% below 1990 levels by 2030 and reach climate neutrality by 2050. EU heads of state endorsed the EU binding climate target for 2030 at a European Council meeting in December 2020.

The EU emission trading system (ETS) – a cap-and-trade system – has been and will continue to be the EU’s principal policy measure to drive emission reductions while preserving the EU internal market and so avoiding “environmental dumping”. The system covers stationary installations and aviation accounting for around 41% of total EU GHG emissions: 10 000 energy intensive installations (power stations and industrial plants) and around 500 airlines must surrender sufficient allowance certificates each year. It is hoped that EU action fosters global action, including more, market-based measures like the EU ETS.

The Commission has proposed to amend the EU ETS Directive in line with the more ambitious climate targets.⁴ The proposal would extend emissions trading to cover maritime shipping, buildings and road transport. At the same time, there would be a regulated diminution in the use of fossil fuels for intra-EU aviation. Rules governing the operation of the market stability reserve (MSR) would be considerably tightened to reduce the number of EU ETS allowances in circulation.

Based on its own projections, the Commission forecasts **carbon prices** in the year 2030 ranging between **50 and 85 €₂₀₂₀/tCO₂e**, but assumes an average of **50 €₂₀₂₀/tCO₂e** in its impact analysis

³ Regulation (EU) 2021/1119

⁴ COM(2021) 551

– this being lower than today’s actual price.⁵ Higher carbon prices will have a macro-economic impact, particularly on poorer member states. The Commission acknowledges, in supporting documentation,⁶ that the proposal to amend the EU ETS raises certain equity issues:

The effects of raising the contribution of emissions trading towards a higher emissions reduction target will not be felt equally across the EU, as their starting point in terms of the emissions in the sectors covered by the Directive are not the same. Some Member States will be more affected than others. Increasing the contribution of the ETS to achieve the revised target will require investments in the energy systems and the greening of industrial processes in Member States where modernisation needs are already the highest. Regions and local communities in which employment is linked to fossil fuel production are impacted more significantly than others.

Employment in the coal sector, in particular, is expected to be around 50% below baseline by 2030. While this is not consequential in terms of total employment at the EU level, it has significant implications for some regions and local communities. Employment in the gas sector is expected to fall significantly as well, though less severely than for coal.

Therefore, the following redistribution measures are proposed:

- **Solidarity redistribution:** comprising the redistribution of 10% of the auctioned allowances to sixteen low-income member states (around 5% of the current overall cap or around 700 million allowances over the 2021-30 period).
- **Modernisation Fund:** up to 2025, 2% of the overall cap or around 275 million allowances over the 2021-30 period, and 4% of the cap from 2026 onwards.
- **Innovation Fund:** 150 million allowances issued under the new emissions trading system for road transport and buildings will be made available to increase the current Innovation Fund of 450 million allowances to stimulate the green transition.
- **Article 10c derogations:** applying to ten low-income member states allows the free allocation (of up to 40% of their regular auction volume) to investments in power generation for the modernisation of the energy sector (totalling about 630 million allowances over the 2021-30 period).

Under the Commission’s proposal, member states would be required to spend all ETS auction revenues on climate- and energy-related projects, including support for low-income households.

Adjustments to the EU budgetary framework will be presented by the Commission as part of the upcoming *Own Resources* package, including a proposal to amend the multi-annual financial framework. This will likely include a proposal for new own-resources taken from the EU ETS – maritime transport, for example – as well as from the proposed carbon border adjustment mechanism.

⁵ SWD(2021)601 part 1, p.35.

⁶ SWD(2021) 557, Commission Staff Working Document: Subsidiarity Grid Accompanying the document Directive amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757, Brussels, 14 July 2021, p.85.

The Commission states in its impacts assessment that all main policy options are proportionate to what is necessary to achieve the at least 55% emission reduction objective in an as cost-efficient way as possible. This overarching imperative means that the actual impacts on the EU economy and the particular impacts on member states have not been considered by the Commission.

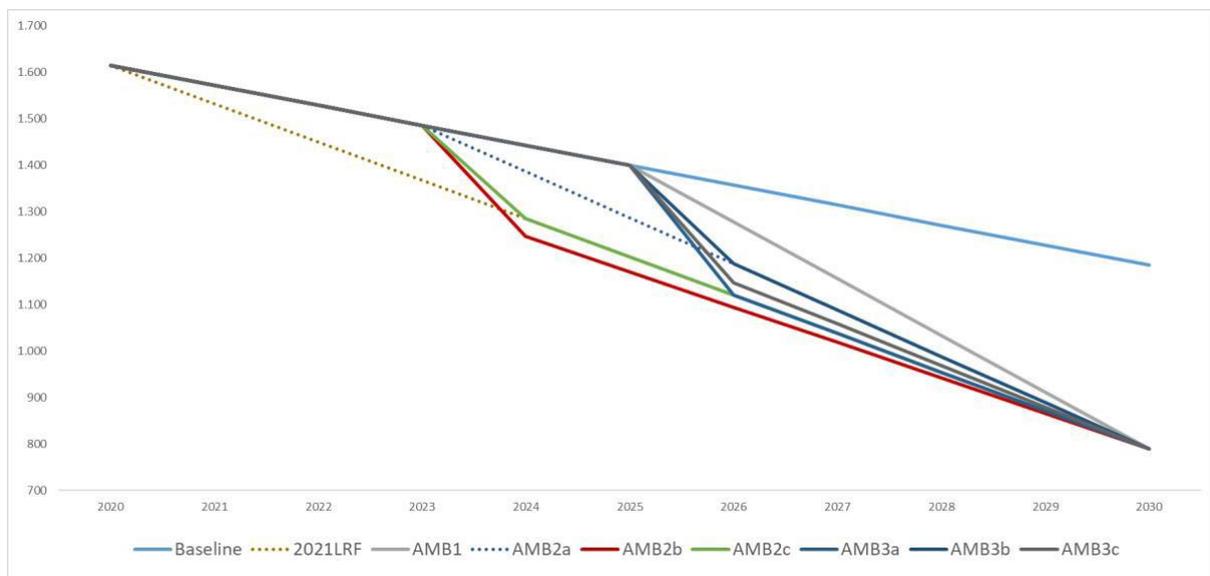
EURACOAL Responses

The EU ETS is subject to significant and repeated political interference such that it carries significant risks to participants. Carbon prices in the EU now largely reflect political decisions rather than market forces. With today’s carbon price, loss-making coal power plants across the EU should have closed. Many have not closed because they are needed to secure electricity supplies in member states. Therefore, governments have been obliged to keep coal plants open using a variety of means which contradict the market-based objectives of the EU ETS.

A revised EU ETS cap for 2030 should allow greater flexibility

Under the third phase of the EU ETS, GHG emissions fell by 31% in 2020 *c.f.* 2005, so well below the politically agreed 21% ETS reduction cap. To reach the EU’s new, tougher climate targets, the Commission proposes to increase the linear reduction factor which defines by how much the EU ETS cap decreases each year. In 2009, the factor was set to 1.74% per year (backdated to 2010) and this continued during ETS Phase 3 (2013-2020).⁷ In 2021, it was increased to 2.2%. Now, it is proposed to increase it to 4.2% per year, as early as 2024.

Figure 2 – Chart showing new EU ETS emission reduction cap to achieve a 61% reduction by 2030 *c.f.* 2005, compared with the current 43% reduction (AMB2c is proposed)⁸



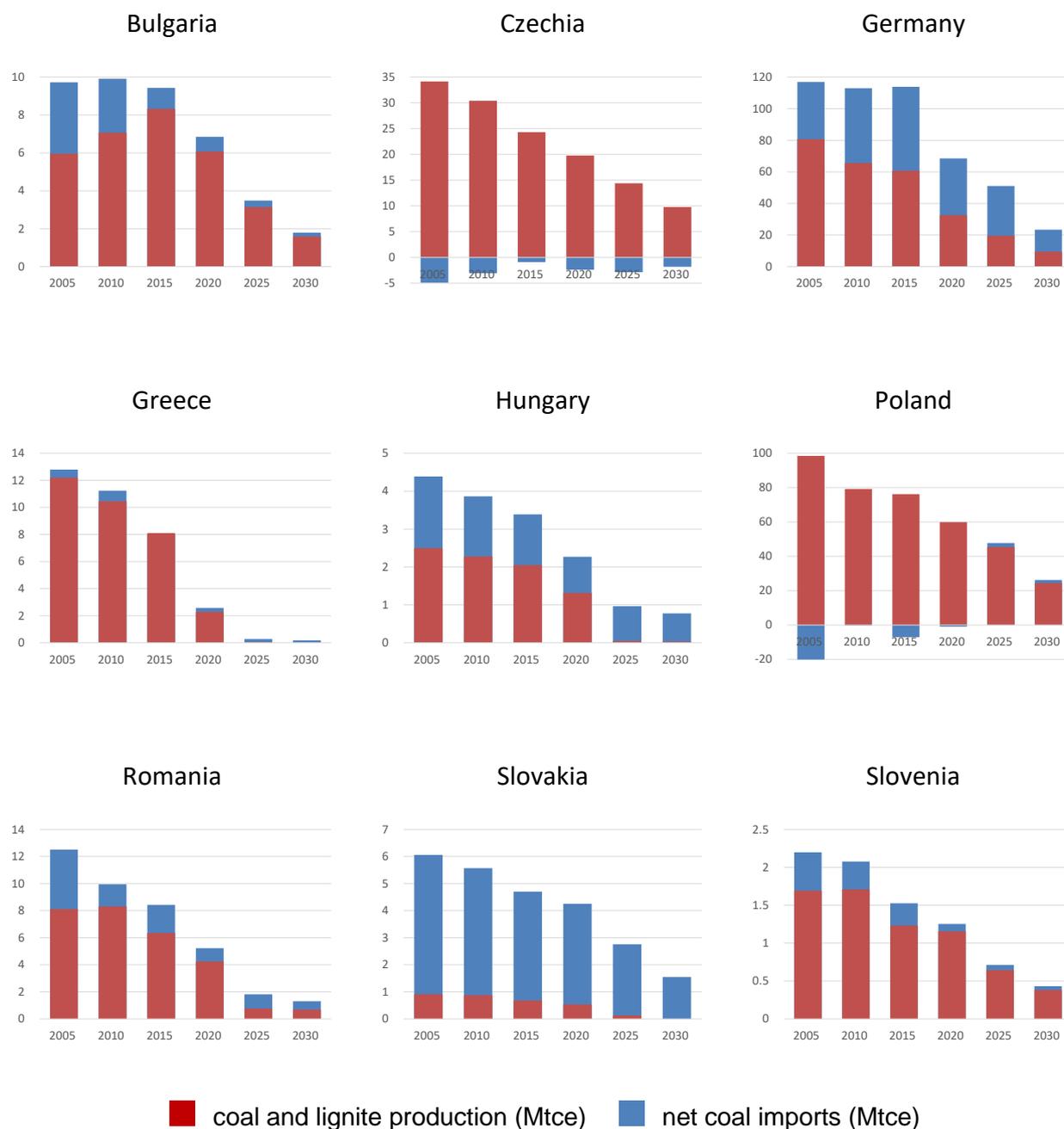
Response

EURACOAL cannot support the proposed new emission reduction targets insofar as they would result in the demise of the coal industry in member states, as shown in Figure 3. However, we recognise that political decisions have been taken at the EU level that make this outcome inevitable. The emission reduction target and annual emission reduction factor proposed by the Commission reflect those political decisions, but more flexibility is called for.

⁷ Directive 2009/29/EC amending Directive 2003/87/EC

⁸ SWD(2021)601 part 1, p.38.

Figure 3 – Impact of the Fit-for-55 package of proposals on coal production and supply in the most important coal-using EU member states⁹



In the Commission’s analysis, baseline emissions are adapted to account for the planned phase-out of coal-fired power-plants in some member states and assumes these will be replaced by gas-fired power plants.¹⁰ The closure of coal power plants is largely driven by the high cost of EU ETS allowances. The system seeks out the lowest-cost emission reductions, destroys these, before further tightening of the system allows it to seek out its next target.

⁹ Technical Note – Delivering the European Green Deal, results of the “Fit for 55” core policy scenarios for the EU Member States, unnumbered report and Excel spreadsheets, European Commission, DG Energy, July 2021.

¹⁰ SWD(2021) 601 part 2, pp.75-76.

The impact of the COVID-19 pandemic is estimated by the Commission to have reduced the demand for EU ETS emission allowances by about 155 MtCO_{2e} in 2020.¹¹ This can be compared with the proposed one-off cancellation of 117 million allowances in 2024, the so-called “rebasing”. EURACOAL notes the moral hazard of announcing a one-off reduction and warned against this in 2013 when the Commission promised that its proposed intervention in the carbon market – the back loading of allowance auctioning – would be a one-off intervention made under “exceptional circumstances”.

Projected carbon price and economic impacts are under-estimated

The accompanying impact assessment projects 2030 carbon prices between 50 €/tCO₂, assuming strong complementary European Green Deal policies as well as the full anticipation of future decarbonisation requirements, and 85 €/tCO₂ with less strong complementary policies.

Commission analysis shows that the share of fuel expenses for buildings in household expenditures would not increase and could even decrease for low-income households by more than 0.1 percentage points, but that cost-effective annual capital costs could be double, increasing by up to 1.4 percentage points of consumption expenditures. This analysis appears to disregard the real challenge for low-income households to make the envisaged capital expenditures in energy efficiency measures.

Coal’s share in the energy demand of the residential sector would fall from 4% of 376 Mtoe to 1% of 291 Mtoe,¹² **an absolute reduction of 81%**. With the introduction of a carbon price, coal end user prices would increase significantly in low-income member states (*ibid.*).

Response

Carbon prices within the EU are already within the range projected by the European Commission for 2030. The nature of the emission trading system means that the unit cost of emission reductions will rise over time, so the projection appears to be an underestimate. In 2015, the Commission similarly used forecasts of future carbon prices when designing and implementing the market stability reserve. At that time, the Commission used a carbon price forecast for the EU ETS Phase 4 (2021-2030) of 25 €/tCO_{2e}. This forecast has proven to be too low, as shown in Figure 4.

The accompanying impact assessment does not assess macro-economic and industrial competitiveness impacts in member states. The macro-economic analysis conducted as part of the impact assessment accompanying the 2030 Climate Target Plan concluded that the impact of an increase in climate ambition to -55% on aggregate employment would be relatively limited, ranging between -0.26% and +0.45% and macro-economic impacts in the range of -0.27% to +0.50% of GDP compared to baseline (assuming no global action).¹³

¹¹ SWD(2021) 601 part 2, p.80.

¹² SWD(2021) part 1, p.119

¹³ SWD(2020) 176 part 1/2 (Table 22 and p.123) accompanying COM(2020) 562, Stepping up Europe’s 2030 climate ambition – Investing in a climate-neutral future for the benefit of our people, 17 September 2020.

Figure 4 – EU ETS allowance prices since the system’s inception in 2005 to September 2021 and Commission forecasts to 2030: impact assessment assumes carbon prices will *fall* to 50 €/tCO₂ in 2030, but they could reach 85 €/tCO₂

(In 2015, the Commission forecast prices of 25 €/tCO₂ for 2021-30; in 2018, it forecast a price of 10-30 €/tCO₂ for 2030; in its outlook to 2050, it forecast 30 €/tCO₂ in 2030; and now in a Fit-for-55 staff working document, prices in 2030 range from 50 to 85 €/tCO₂)¹⁴



EU ETS scope should exclude heat and power generated from fugitive methane

To date, the scope of the EU ETS has been clear: all combustion plants >20 MW_{th}. This has left a small number of plants sitting at the margin, with unintended outcomes. The Commission proposes to address this by changing the scope of the EU ETS by:

- i. specifying that installations stay within the EU ETS (for up to five years) where they reduce the total capacity of their combustions units to reduce GHG emissions (*e.g.* through electrification) (Article 2, paragraphs 1 & 2);
- ii. making the definitions of activities technology neutral (removing references to fossil fuels or specific production processes);
- iii. referring to production capacities instead of combustion capacities; and
- iv. reviewing the benchmark definitions to ensure equal treatment of installations independently of the technology used, including when using low- or zero-carbon technologies.

In the case of installations with multiple combustion units,¹⁵ the Commission proposes to aggregate all those above 3 MW_{th} when determining if an installation is above 20 MW_{th} and so within the scope of the EU ETS.

¹⁴ SWD(2015) 135 (25 €/EUA average during Phase 4), COM(2018) 773, 20121112_swd_en.pdf (10-29.2 €/EUA), EU Energy, Transport and GHG emissions Trends to 2050 – Reference scenario 2020 (30 €/EUA), and SWD(2021) 601 (50-85 €/EUA)

¹⁵ *i.e.* technical units such as boilers, burners, turbines, heaters, furnaces, incinerators, calciners, kilns, ovens, dryers, engines, fuel cells, chemical looping combustion units, flares, and thermal or catalytic post-combustion units

Response

This proposal sets a worrying trend whereby even “clean” processes continue to attract regulatory oversight. It is not clear what the benefits are of such ongoing regulation after a process has been decarbonised.

The proposed aggregation may result in some coal mine methane (CMM) projects falling under the EU ETS where a number of individual units (reciprocating engines) are above around 1.2 MW_e. These projects have impressive environmental benefits by efficiently mitigating the very potent GHG methane, including at abandoned coal mines. They should be treated similarly to waste incineration plants and be explicitly exempted from aggregation. Such a support measure would be in line with the EU Methane Strategy. Moreover, CMM plants should generally be exempted from the EU ETS, including plants larger than 20 MW_{th}. Too few such projects have been implemented in the EU, partly because of the strict limits of the EU ETS. This is a missed opportunity to effectively tackle EU methane emissions. An explicit exemption, as detailed below in Figure 5, would encourage companies to realise CMM projects, including larger ones, as a means to efficiently reduce GHG emissions.

Figure 5 – Suggested amendment to the EU Emissions Trading System Directive 2003/87/EC

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DIRECTIVE (EU) 2018/410 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 14 March 2018

amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814

(Text with EEA relevance)

ANNEX I

CATEGORIES OF ACTIVITIES TO WHICH THIS DIRECTIVE APPLIES

1. Installations or parts of installations used for research, development and testing of new products and processes and installations exclusively using biomass or coal mine methane collected at operating or abandoned coal mines and used in installations for heating/cooling and/or the production of electricity are not covered by this Directive.
2. The thresholds values given below generally refer to production capacities or outputs. Where several activities falling under the same category are carried out in the same installation, the capacities of such activities are added together.
3. When the total rated thermal input of an installation is calculated in order to decide upon its inclusion in the EU ETS, the rated thermal inputs of all technical units which are part of it, in which fuels are combusted within the installation, are added together. These units could include all types of boilers, burners, turbines, heaters, furnaces, incinerators, calciners, kilns, ovens, dryers, engines, fuel cells, chemical looping combustion units, flares, and thermal or catalytic post-combustion units. Units with a rated thermal input under 3 MW and units which use exclusively biomass or coal mine methane collected at operating or abandoned coal mines and used in installations for heating/cooling and/or the production of electricity shall not be taken into account for the purposes of this calculation. ‘Units using exclusively biomass’ includes units which use fossil fuels only during start-up or shut-down of the unit.

Activities	Greenhouse gases
Energy activities	
Combustion installations with a rated thermal input exceeding 20 MW (except hazardous or municipal waste installations <u>or installations using coal mine methane collected at operating or abandoned coal mines for heating/cooling and/or the production of electricity</u>)	Carbon dioxide Other specialised pollution-control activities

Cogeneration and district heating should be encouraged

The Commission proposes to treat all cogeneration plants – utility and industrial – in the same way so that they can benefit from free allowance allocations for the supplied heat (and cooling). In the buildings sector, cogeneration would be included in the new ETS insofar as installations supply heat to commercial, institutional and residential premises, either directly or through district heating systems. The exception for the financing of fossil fuel-fired district heating in certain member states would be removed.

Response

EURACOAL is concerned that this proposal would favour new, fossil gas-fired combined heat and power generation in the marketplace and will therefore be detrimental to efficient coal-fired heat and power generation. In the case of heat supplied, we question whether the term “economically justifiable demand” can ever be legally sound: it is highly subjective and therefore not legally enforceable. In the case of district heating, the current exception for fossil fuels should be retained as there is not always an economic alternative means to provide such heat.

Carbon capture and use is a necessity

The Commission proposal establishes that surrender obligations do not arise for emissions of CO₂ that end up permanently chemically bound in a product, such as carbon-based engineering materials, so that they do not enter the atmosphere under normal use (Articles 3(b) and 12(3b)).

Response

EURACOAL welcomes the continued support and attention that the Commission gives to CCS and CCUS. These carbon capture technologies will become increasingly important as operators of processes with high abatement costs look to find ways to reduce the rising financial burden of purchasing EU ETS emission allowances.

Market Stability Reserve has not led to stability

A market stability reserve (MSR) began operating in 2016,¹⁶ and was strengthened in the 2018 revision of the EU ETS.¹⁷ The MSR can reduce the total number of allowances in circulation (TNAC) by absorbing a part of the auction volumes or increase the TNAC by releasing additional allowances for auctioning. The MSR absorbs or releases allowances if the TNAC is outside a predefined range:

- If the TNAC is above 833 million allowances, then 12% (or currently 24%) of the allowances are removed from the volumes to be auctioned and placed in the MSR;
- If the TNAC is below 400 million allowances, then 100 million allowances are released from the MSR and auctioned.

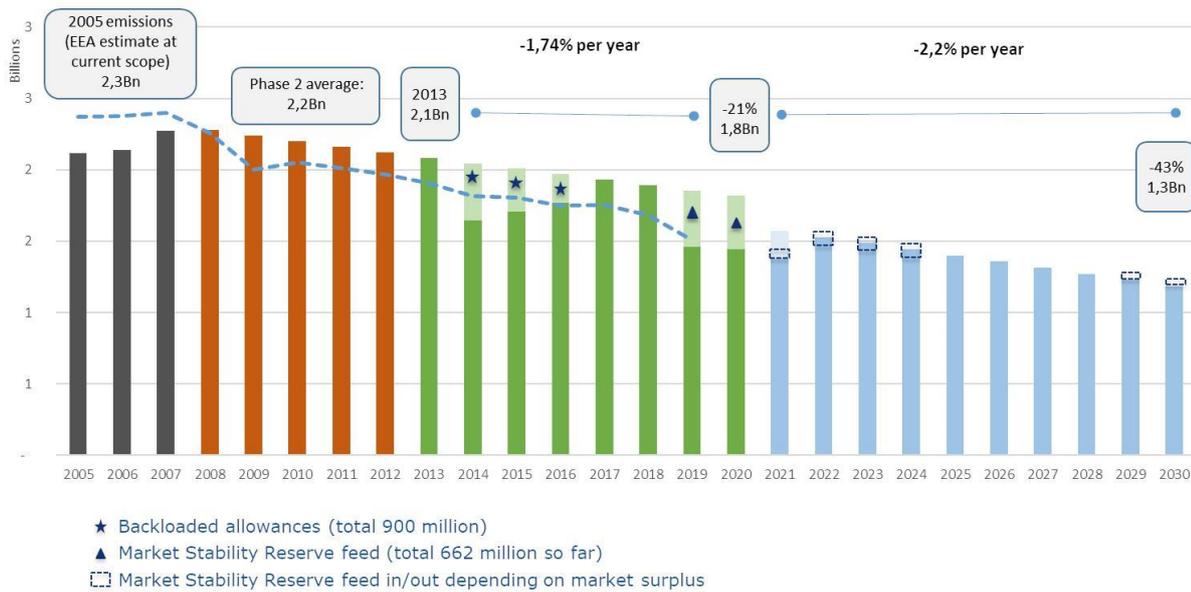
These thresholds are based on an assessment by the Commission of how much liquidity the market needs to function well, which crucially depends on the need for installations to manage their carbon price risks through hedging part of their need for allowances in advance.¹⁸

¹⁶ Decision (EU) 2015/1814, 6 October 2015

¹⁷ Directive (EU) 2018/410, 14 March 2018

¹⁸ SWD(2021) 601 part 1, p.39

Figure 6 – Cap reduction with increase of Linear Reduction Factor to 2.2% as of 2021¹⁹



An apparent allowance “surplus” of around 1.75 billion allowances in Phase 2 (2008-2012) has been reduced, firstly by backloading and secondly by the MSR. From 2023, the strengthening of the MSR would see allowance permanently cancelled or “invalidated” to limit the size of the MSR to the previous year’s auction volume. In May 2021, TNAC was reported by the Commission to be 1 578 772 426 on 1 April 2020, a figure which excludes 772 749 992 allowances removed to the MSR plus 900 000 000 temporarily removed to the MSR by backloading.²⁰ Thus, the MSR grew to almost 2 billion allowances in 2020 as 24% of the TNAC was syphoned off. Figure 7 shows a water-flow representation of the EU ETS and MSR in operation.

The Commission proposes to further strengthen the MSR to absorb the perceived surplus of allowances more quickly **by maintaining the annual intake rate of allowances at 24% until 2030**, this being double the normal 12%. The hard trigger of 833 million TNAC allowances which resulted in removals will be replaced with a smoother removal of allowances, the number being proportional to the calculated surplus above the threshold. The Commission believes that the proposed threshold “sits within the range of the estimated amount of market surplus required for hedging between 2025 and 2030”.²¹

In addition, the Commission proposes a one-off “rebasings” to remove 117 million allowances. It is also proposed to gradually **limit the number of allowances in the reserve to 400 million allowances**, rather than the previous year’s auction volume (594 million allowances in 2019).²² By 2030, the Commission forecasts that 3.0 to 3.5 billion allowances will have been invalidated and therefore never released from the MSR back into the market.²³ Overall, the Commission wishes to “ensure that the surplus reaches the volume bandwidth within which the carbon market is deemed to operate in a balanced manner”.

¹⁹ Report on the functioning of the European carbon market, COM(2020) 740, European Commission, 18 November 2020, Brussels.

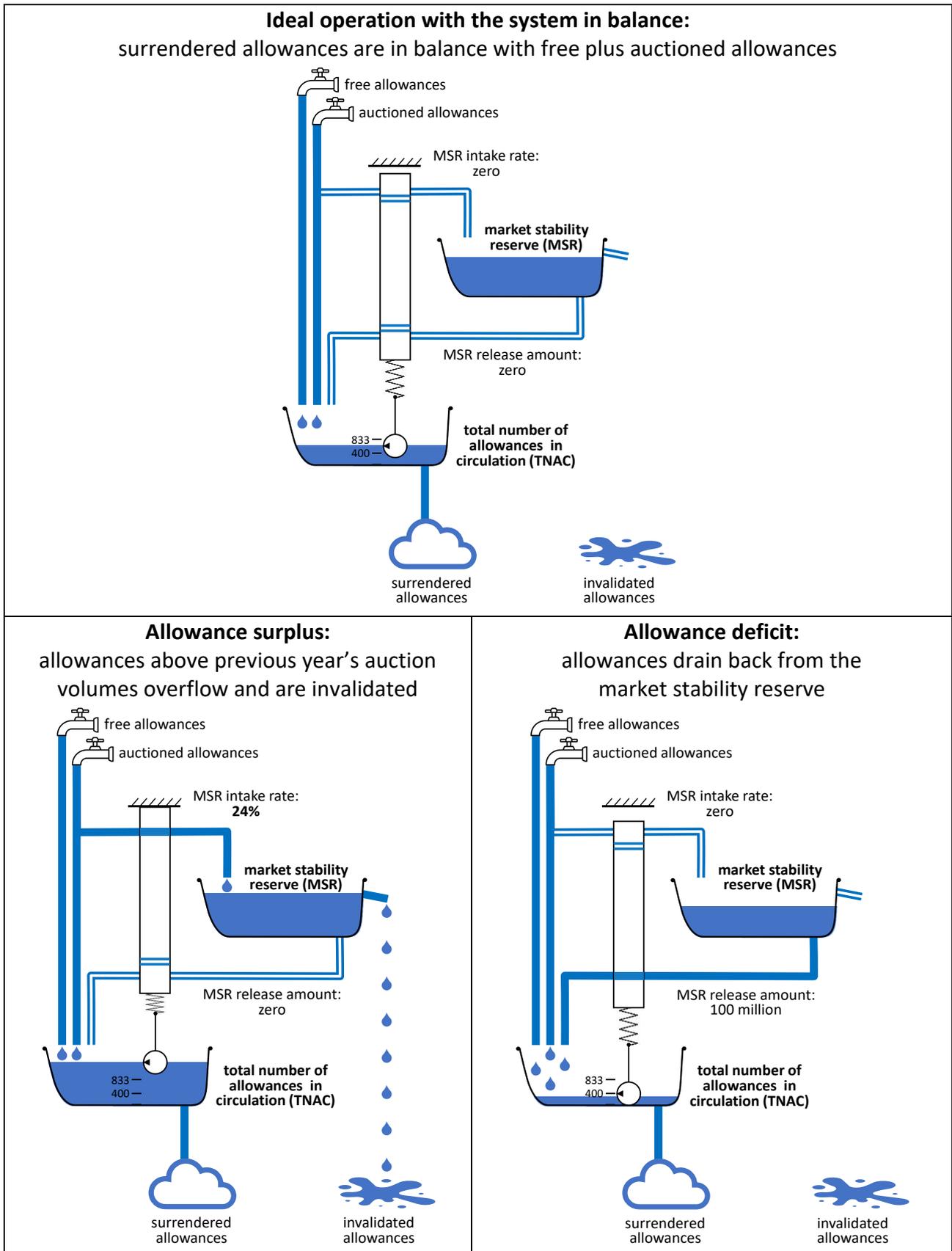
²⁰ COM(2021) 551, p.15 and C(2021) 3266 final, 12 May 2021

²¹ SWD(2021) 601 part 1, p.74.

²² COM(2020) 740, 18 November 2020

²³ SWD(2021) 601 part 1, p.71.

Figure 7 – Diagrams of current MSR operation – 57% auctioned²⁴

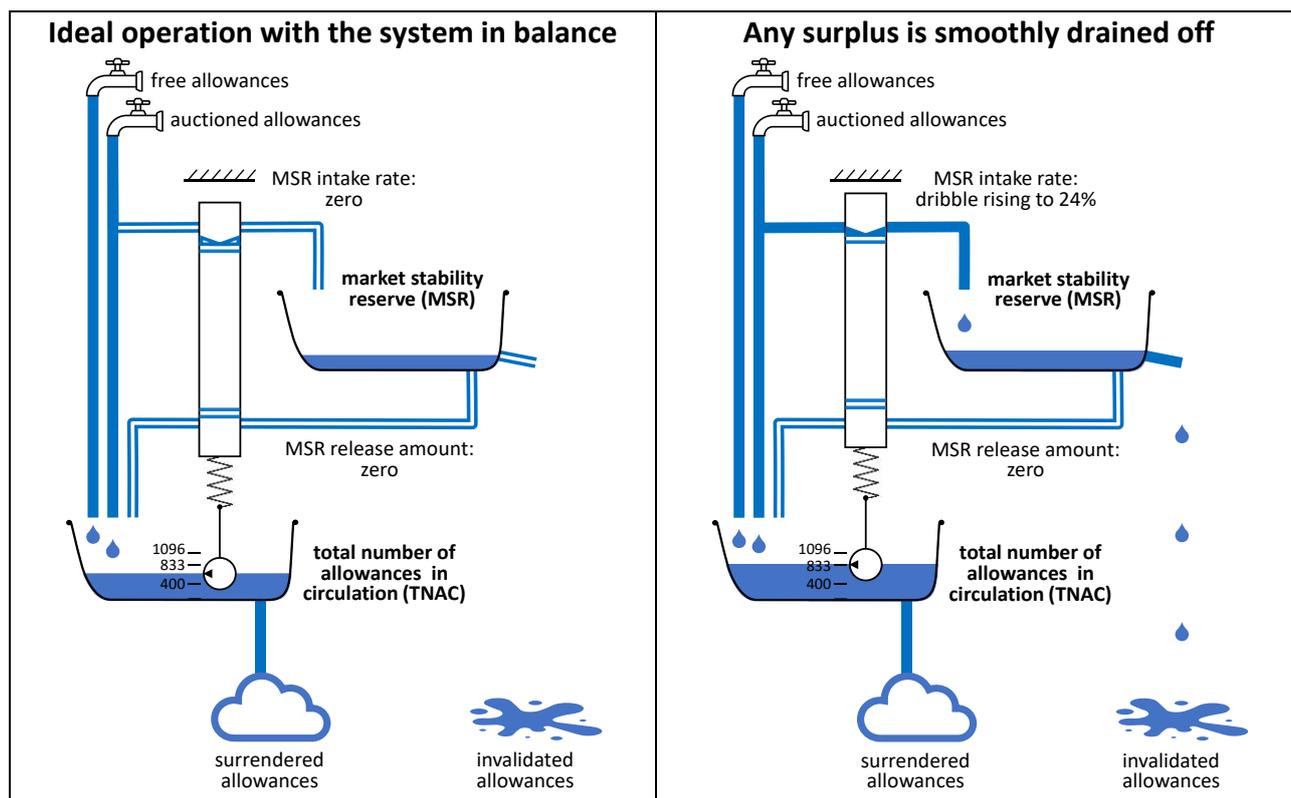


²⁴ SWD(2021) 601 part 1, p.85

The Commission amendments are shown in Figure 8. These should ensure a smoother operation of the MSR by replacing the bang-bang valve that fills the reserve with a proportional valve. Any allowances above the 833 million threshold are removed, until the volume removed equals 24% of the TNAC volume – a point reached when TNAC is 1 096 million allowances. After that point, 24% of TNAC is removed annually. This should remove market uncertainty and shocks caused by the MSR kicking in suddenly at 24% once the intake threshold has been reached.

Finally, the Commission proposes to review the operation of the MSR in 2028.

Figure 8 – Diagrams of MSR operation after proposed amendment



Response

While some major players buy EU ETS allowances from the market only when they need to surrender them to cover their previous year’s emissions (by 30 April of the following year), others are fully hedged out to 2030. Hedging operations add to the total number of allowances in circulation (TNAC), even though they are held to cover future emissions, not the past emissions used in MSR calculations. As such, the aggregate effect of long-term hedging forces the MSR to repeatedly withdraw allowances from a market that always appears to be in surplus. This means too few allowances enter the market via auctions to meet current demand from those who wish to cover their previous year’s emissions. Prices rise and eventually destroy demand, unless those with hedging positions sell and return to the market the allowance supply assumed in MSR calculations. This problem can be addressed by retaining a sufficient number of allowances in the MSR: **EURACOAL proposes the reserve is maintained at the previous year’s volume of allowances surrendered.**

Analysis by EURACOAL members shows that the upper threshold of 833 million allowances can be compromised by the operation of withdrawing allowance to the MSR. This is because of the

delay in calculating and reporting TNAC (in May of the following year) and the resulting schedule of monthly removals. For example, a modest allowance surplus in 2021 of say 230 million allowances – perhaps used for legitimate hedging – could result in monthly withdrawals from September 2022 to August 2023 that pull TNAC below 600 million allowances. This unintended fault within the MSR can be corrected by setting a higher threshold: **EURACOAL proposes that the threshold be corrected to 1 145 million allowances** – this being the average EU ETS Phase 4 annual cap.

The MSR means that the EU ETS now goes beyond reaching the politically agreed GHG reduction targets. The system now *exceeds* these targets. Other EU and national policies, such as renewable energy policies or coal phase-outs, reduce demand for EU ETS allowances to create a “surplus” which, in a market-based system, would become available to other EU ETS participants. Instead, the MSR removes this surplus with the result that the EU ETS no longer seeks out least-cost carbon reductions, but instead imposes the same high carbon price across all industrial sectors, a high carbon price that is not determined in the market, but by the operation of the EU ETS itself – as shown by the evolution of EU carbon prices since 2019 (Figure 4) – a period when market theory would have anticipated lower carbon prices as allowance demand fell during the COVID-19 pandemic. Indeed, the Commission acknowledges that the lack of competitiveness of coal is “in itself mainly driven by carbon prices”.²⁵ The EU ETS functions more like a carbon tax than a trading system.

The Commission claims that the market stability reserve “stabilises the market by removing surplus allowances from it”.²⁶ Unfortunately, the EU carbon market has been far from stable since the MSR was introduced in January 2019. Since then, EU carbon prices have risen by 140% in just 32 months, compounding the impacts of the worst global economic shock outside of peacetime since the Great Depression. EURACOAL members would like to see an analysis of the impacts of the current and proposed EU ETS legislation on the EU economy – an analysis that may exist in an unpublished report for the Commission by Vivid Economics.²⁷

Emissions trading for buildings and road transport is too bureaucratic

The Commission proposes to regulate fuel suppliers (defined in line with the recently updated EU excise duty system)²⁸ rather than fuel-using households or vehicle drivers. If passed by legislators, the new, complementary emissions trading scheme would become operational from 2024 for a two-year administrative pilot phase to allow fuel supply businesses to prepare for full operation with trading from 2026. A cap on emissions would be set from 2026, declining linearly over time to give a 43% emission reduction in 2030 compared to 2005. The cap would be set to 1 109 304 000 tCO₂ for the year 2024, this being the emissions during the 2016-18 reference period, and then reduce by a linear reduction factor set at 5.15% of this cap, with no free allocations. In 2026, the auction volumes would be 30% higher than the total quantity of allowances for 2026 to provide headroom for hedging and advance purchases.

The regulated entities in the buildings and road transport sectors have no experience with emissions trading or its practical implications. However, the Commission believes that fuel suppliers usually

²⁵ SWD(2021) 601 part 1, p.12

²⁶ Q&A, 14 July 2021

²⁷ Vivid Economics, (2021), “Review of the EU ETS Market Stability Reserve”, report prepared for DG CLIMA, publication upcoming.

²⁸ Council Directive (EU) 2020/262 of 19 December 2019 laying down the general arrangements for excise duty (recast) (OJ L 58, 27.2.2020, p.4-42)

do have experience in dealing with fuel taxation and related administrative procedures, so can adapt to trading. However, for coal sales, administrative costs would be higher. There are many, sometimes very small coal suppliers – an estimated 3 000 – which until now are hardly regulated. In most member states that apply excise duty to coal, the seller to the final customer is the excise duty payer, but there are many exceptions.²⁹ As it is very little taxed, the impact on consumer coal prices of a 48 €/tCO₂ carbon price would be comparatively much larger than for fossil gas or heating oil, with an **EU average impact estimated of 52% and up to nearly 100% in some member states.**³⁰

Suppliers of coal for heating, known as “coal merchants”, would become “regulated entities” and required to participate in the new ETS. The Commission envisages that this would encourage coal merchants to supply lower carbon fuels in the future.

In the case of coal, there is no harmonised tax warehouse system applicable in all member states, so not all coal products necessarily pass through an excise duty point. There is no obvious point of regulation; every option carries significant complexities. For a selection of the ten member states (BG, CZ, DE, HU, IE, IT, LT, PL, SK, ES) which are most relevant in terms of coal use, either for heating or for (small) industrial use, an analysis by the Commission of their coal excise regimes found that all charge excise duties on coal, albeit with a number of exemptions and reductions. The point of duty payment varies: in most countries, the seller to end consumer collects duty, in others it is the coal importer or producer (DE, IE, ES), and some require the end consumer to pay. Given this structure, the Commission proposes coal merchants calculate emissions from sold coal products and purchase the corresponding number of emission allowances. The Commission suggests that coal merchants, or groupings of merchants would employ financial advisors such as corporate banks to arrange allowance purchases and hedging.

The Commission estimates the administrative costs for a coal merchant would include set-up costs ranging between € 6 085 and € 8 590 (207 hours) plus recurring costs of between € 4 900 and €6 350 (61 hours and annual verification costs of € 1 400 by an accredited agent), depending on hourly rates (29.4 to 41.5 €/hour). It is assumed these costs would be passed on to consumers. The administrative impacts would be significant, both for the regulated entities (especially for small coal merchants) and for the national administrations in terms of participants’ identification, supervision, enforcement and fraud prevention.

For the new trading system covering road transport and buildings, a “highly reactive” market stability reserve is proposed with additional measures to mitigate the risk of excessive price increases and volatility, due to factors other than changed market fundamentals, through the release of allowances from the reserve under certain conditions. If new allowance prices double (or triple) during a 3 month period, compared with the preceding 6 month period, then the Commission proposes to release 50 million (or 150 million) allowances from the new MSR.³¹

²⁹ In Czechia, France, Croatia, Italy, Latvia and Slovakia the supplier to end-consumer of coal is the party that pays the tax whereas in Germany, Ireland and Spain the first supplier of coal is appointed as the responsible party for paying the tax. In the vast majority of countries multiple entities can be liable for paying the tax depending, amongst others, on the moment when the coal duty/tax becomes chargeable. This includes parties such as tax warehouse owners, producers, importers, suppliers, traders, consumers or the tax representative of one of these parties. SWD(2021)601 part 1, p.57.

³⁰ SWD(2021) 601, p.126

³¹ COM(2021) 551

The Commission anticipates that the two, separate trading schemes would ultimately converge and be combined, hence the new scheme for buildings and road transport is introduced as an amendment to the EU ETS Directive. As such, the Commission proposes a review of the new scheme by 1 January 2028 with the objective of “increased prices convergence” and wishes to be granted substantial implementing powers to achieve that objective.

Response

EURACOAL welcomes the proposal to create a separate but adjacent emission trading scheme for buildings and road transport as this will allow two different price signals: one for those large emitters under the EU ETS whose business activities are sensitive to the price of carbon, and one for other fossil fuel users who are far less sensitive to carbon pricing, because this would represent a smaller part of their fuel bills.

In practice, the proposal would result in short-term switching from coal to wood or processed biomass which would have unpredictable impacts on wood supply, local air pollution and the performance of heating appliances. In the longer term, coal merchants would be driven out of business as coal users switch to gaseous fuels or electricity. Fossil gas suppliers would be the clear winners from the proposal as drafted.

The estimated 3 000 regulated coal suppliers do not appear to include the many petrol station forecourts, DIY stores, supermarkets and hypermarkets that sell pre-packed solid fuels to final consumers. **EURACOAL suggests that the number of regulated entities would far exceed the Commission’s estimate.**

Modernisation Fund should not exclude fossil fuels

The Commission proposes to double the size of the Modernisation Fund, increasing it from 2% of total EU ETS allowances to 4.5%. The fund currently covers the 2021-2030 period to the benefit of ten member states with a *per capita* GDP below 60% of the EU average (BG, CZ, EE, HR, LV, LT, HU, PL, RO, SK). The additional 2.5% would be used to support Commission-approved projects in those member states with a *per-capita* GDP below 65% of the EU average, thus adding Greece and Portugal to the list.

The Commission proposes that “No support from the Modernisation Fund should be provided to energy generation facilities that use fossil fuels.” (Article 10(d) paragraph 1)

Response

The increased Modernisation Fund under the EU ETS Directive supports investments in modernising the power sector and wider energy systems, boosting energy efficiency, and facilitating a just transition in coal-dependent regions in lower-income member states. This complements other instruments such as cohesion policy and the Just Transition Fund. EURACOAL welcomes such support. However, the Modernisation Fund should be available for high-efficiency fossil fuel energy generation, such as cogeneration or combined heat and power (CHP), whether coal- or gas-fired, providing they are “good quality”.

Innovation Fund is welcome

The Innovation Fund, currently sourced from 450 million allowances from the EU ETS in 2021-2030, would be topped up with 50 million allowances – partly from the allowances that would otherwise be auctioned, and partly from those that would otherwise be freely allocated to industry – and 150 million allowances from the new trading system for road transport and buildings. Under the proposed carbon border adjustment mechanism (CBAM), free allocations to industry would be wound down more quickly from 2026: by 10 percentage points each year to reach 0% in 2035.

As well as innovative renewable energy sources, e-fuels³² and energy storage technologies, the Innovation Fund should stimulate the construction and operation of projects aimed at environmentally safe CO₂ capture and storage (CCS) in “geographically balanced locations”. The Commission proposes that it is given implementing powers to set the accounting rules for e-fuels, as well as other fuels from renewable sources.

The Commission also proposes to introduce carbon contracts for difference (CCDs) to guarantee investors in innovative climate-friendly technologies a fixed price that rewards CO₂ emission reductions above the current price levels in the EU ETS. The scope of the Innovation Fund would therefore be extended to allow it to provide support to projects through competitive tendering mechanisms such as CCDs.

Response

EURACOAL welcomes the increased size and scope of the Innovation Fund, but notes that the large capital flows might be better managed and invested in the private sector where they would be subject to shareholder scrutiny and market competition.

Social Climate Fund might be too small

While 90% of auctioning revenues fall to member states, the EU ETS Directive’s solidarity provision sees the redistribution of 10% of the auctioned allowances to sixteen low-income member states (BG, CZ, EE, EL, ES, HR, LT, CY, LV, HU, MT, PL, PT, RO, SI, SK). Currently, all auction revenues under the solidarity provision and at least 50% of member states’ auctioning revenues should be used for climate purposes.

Noting that costs are projected to rise by an order of magnitude more for the poorest EU households than for the richest,³³ the Commission proposed a new Social Climate Fund to address the social challenges that vulnerable households may face, and to alleviate the impact of high energy prices on microenterprises and transport users. This new EU fund would be launched one year ahead of the introduction of an emissions trading system for buildings and road transport. The intention is that member states support energy-saving measures and low-emission transport using money from the new fund, as well as providing income support to the those living in energy poverty – reportedly 6.9% of EU citizens – and mobility poverty. The fund would be financed by the EU budget, using an amount equivalent to 25% of the expected revenues of the new ETS for buildings and road transport. It is expected to provide € 72.2 billion of funding over the period 2025-2032 to member states who have had their Social Climate Plans approved by the Commission.

Response

EURACOAL supports the use of EU ETS auction revenues to mitigate the social impacts of the energy transition, with compensation to those households who cannot afford rising energy prices. Half of the revenues should be used explicitly for this purpose, while the other half should be used for climate and energy related projects – as is currently the case.

EURACOAL is concerned that the proposal would effectively increase the EU budget by the back door. A political agreement has been reached on the overall size of the EU budget at around 1.1% of GNI for the period 2021-2027. This multi-annual financial framework (MFF) would be somewhat disrupted under the proposal because the internal budgets of member states would effectively become an extension of the EU budget – EU ETS auctioning revenues could only be

³² e-fuels are defined by the Commission as “recycled carbon fuels and renewable liquid and gaseous fuels of non-biological origin” produced using captured CO₂.

³³ SWD(2021) 601 part 4, p.85.

used for purposes sanctioned by the European Commission. The proposed hypothecation of funds might not match the particular priorities of member state governments. Moreover, by extending its reach to social policy to address the aims of Article 151 of the Treaty on the Functioning of the EU, the Commission’s proposal should be assessed under Article 114 of the Treaty insofar as it applies on environmental taxation. Thus, decisions at the EU level to hypothecate EU ETS auction revenues can only be approved unanimously according to Article 352 of the Treaty – it is not credible to claim that the EU ETS falls solely under the remit of Articles 191 to 193 of the Treaty on environmental protection and can thus be agreed by QMV.⁶ The justification that “In light of the emission reduction target for 2030, and in the perspective of the climate neutrality objective to be achieved by 2050, stronger EU action is needed.” is too open-ended to be compatible with the principle of subsidiarity. It can be used to justify an EU-wide GHG trading system, but not the accompanying measures that relate to budgetary and social policies.

Maritime transport – higher import costs

The Commission proposes to extend the scope of the EU ETS to include CO₂ emissions from all vessels above 5 000 gross tonnes. This would account for all emissions from ships calling at EU ports for intra-EU voyages, and 50% of emissions for extra-EU voyages. The resulting price signal should incentivise greater energy efficiency, such as slow steaming (which the Commission views positively as it “can reduce underwater noise and reduce negative impacts on habitats”)³⁴, and the use of low-carbon alternative fuels in place of bunker fuel. The related FuelEU Maritime proposal would promote the use of alternative, low-carbon fuels.

Response

EURACOAL notes that the proposal to include shipping in the EU ETS would effectively be a tax on imported goods such as coking coal and steam coal which might therefore favour indigenous coal producers – an outcome that we support.

Aviation – an opportunity for e-fuels

Flights within the European Economic Area (EEA), as well as flights to Switzerland and the UK, are covered under the EU ETS. The Commission proposes that the total number of aviation allowances should be capped at current levels and reduced annually by a linear reduction factor of 4.2%, effectively starting in 2021 (a one-off reduction would be made one year after entry into force). The allocation of free allowances to airlines would stop by the end of 2026. Unless alternative, low-carbon fuels become widely available, this points to a curtailment of intra-EU flights. In the case of extra-EU flights, the Commission proposes to implement a Carbon Offsetting and Reduction Scheme for International Aviation (CORSA) that would effectively cap emissions at 2019 levels by requiring offsets of any additional emissions.

Response

EURACOAL members recognise the opportunities created with a growing market for low-carbon alternatives to kerosene-based jet fuel and avgas, but cautions that the proposed CORSA scheme could result in the double counting of carbon emission reductions or the double subsidising of renewable energy projects. The multiplying number of schemes – EU ETS, EU ETS for aviation, new ETS for buildings and road transport, CORSA and others – risks creating multiple layers of bureaucracy that have a negative impact on EU productivity.

29 October 2021

³⁴ SWD(2021) 601 part 1, p.98.