

Vattenfall position on revising the EU ETS directive in support of higher EU climate ambitions for 2030 and 2050

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Vattenfall fully supports the EU's goals of becoming a climate-neutral economy by 2050 and achieve at least -55 % reductions of the net GHG emissions by 2030. **Now it is urgent that all relevant EU climate and energy policy legislations are agreed and enter into force as soon as possible**, so that all parts of the society can jointly contribute to deliver these GHG emission reductions cost-efficiently and timely in the short timeframe that remains until 2030.

The **EU ETS should play a central role in reaching the EU's climate targets** with regards to the sectors it covers. Most importantly, the ETS allowance cap must be aligned with the EU's new climate ambitions, but there are also other reforms that can further improve the system:

- **A higher Linear Reduction Factor (LRF) of 4.2 % should be adopted and implemented swiftly.** It is absolutely essential that the new LRF **takes effect already from 2023, or 2024 at the latest.** It will require, however, that **a one off reduction of the ETS cap ('rebasin')** is also made for setting the ETS allowance trajectory on the right course from an early stage.
- It is important to ensure that the **Market Stability Reserve (MSR)** continues to have a strong ability to tackle exceptional events in the future. Therefore, some design parameters must be updated. More specifically, **the MSR's intake rate should be kept at 24 % (at least)** and the **MSR's activation thresholds need to be reduced**, in order to reflect the increasingly decarbonised energy system and lower hedging needs in the power sector in particular.
- The rule-based **permanent cancellation (invalidation) of the most excessive surplus of EUAs in the MSR** needs to continue in the future. This is crucial to ensure that there is long-term scarcity in the EU ETS market and to avoid that the surplus of EUAs returns later.
- The supply of ETS allowances needs to be **adjusted to reflect the lowering of CO2 emissions by overlapping policies** at EU and national level. In that context, it should be considered if the currently voluntary withholding of EUA supply linked to national policy measures in the power sector should be made more direct, predictable and mandatory.
- The EU ETS should be **expanded to other sectors and regions** where appropriate. However, the **road transport sector is not suited** for a direct inclusion into the existing EU ETS. Hence, the Commission's proposal on setting up a separate and adjacent ETS for the buildings and road transport sectors is a better approach to address these CO2 emissions.

Contact persons:

Erik Filipsson (erik.filipsson@vattenfall.com)
Claire Sandevour (claire.sandevour@vattenfall.com)

Vattenfall is a European energy company with approximately 20,000 employees. For more than 100 years we have electrified industries, supplied energy to people's homes and modernized our way of living through innovation and cooperation. Our goal is to make fossil-free living possible within one generation. Everything we do and the decisions we take shall lead to this goal. This is the basis of Vattenfall's strategy, and we advocate for a regulatory environment that makes this transition possible – in the energy sector and beyond in transport, industry etc.



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The EU 2030 climate and energy policy framework should be swiftly updated and the effort must be equally shared between all sectors

In April 2021, the EU enshrined a new 2030 climate target of at least -55 % net GHG emissions reductions by 2030 (vs. 1990) into the first EU climate law. Now it is **important that the EU 2030 climate and energy policy framework is swiftly updated** to steer towards the agreed new climate ambitions. We welcome the European Commission's 'Fit-for-55 package' from July 2021 and emphasize that this large set of legislative amendments must be addressed with priority by the European Parliament and the Council of the EU. The additional effort of reducing emissions associated with the increased climate ambition should be fairly and cost-efficiently distributed between the sectors regulated by the EU ETS and the sectors covered by the ESR.

The EU ETS directive should be further improved and aligned with the EU's recently increased climate ambitions for 2030 and 2050

Vattenfall believes that the EU ETS should be the principal instrument to achieve the EU's climate targets with regards to the sectors that it covers. Following the latest revision of the EU ETS Directive, the policy has been significantly improved and induced a CO₂ price that has clearly contributed to the phase-out of coal. In the turbulent situation caused by the Covid-19 pandemic since 2020, the EU ETS policy has also showed a large degree of robustness, that would not have been possible without the Market Stability Reserve (MSR). The EU ETS has proved its ability in practice, and now it is time to make it steer towards more ambitious goals.

A higher LRF is needed to put the ETS cap trajectory on track to the EU's climate ambitions and it should take effect already from 2023

Today, less than 9 years remain to deliver on the EU's new target to reduce the union's GHG emissions by at least -55 % until 2030. A swift implementation of the reforms and early action to further reduce the GHG emissions in the coming decade will make the EU decarbonisation pathway towards the agreed 2030/2050 climate targets more predictable and cost-effective.

Vattenfall supports the new Linear Reduction Factor (LRF) of 4.2 % as proposed by the European Commission and believes that it should **take effect already from 2023** or 2024 at latest. The later the new LRF starts to apply, the higher the LRF has to be, to arrive at the same target level in 2030 and 2050. A realistic and desirable start date of a new LRF would be 1 January 2023, but that requires that the co-decision process does not get delayed. Next to the start date, the actual level of the updated LRF is also highly dependent on whether a 'rebasings' of the ETS allowance cap is done in connection to the new LRF starting to apply.

A rebasing of the ETS cap is needed to better reflect the actual CO₂ emissions and to create a smooth cap trajectory towards 2030

Vattenfall fully supports the Commission's proposal for a **one-off reduction (rebasings) of the ETS baseline** and how its size is directly linked to the actual start date of the new LRF. For many years, the EU ETS allowance cap has been significantly higher than the verified CO₂ emissions in the system. This is a result of a combination of rapidly decreased CO₂ emissions in the power sector particularly and the fact that the LRF agreed in the previous ETS reform is too low and has just started to apply. Therefore a rebasing is needed to swiftly align with the EU ETS cap trajectory that would be the case if the new LRF would have been applied from the start of Phase 4 (2021). Without a rebasing in the first half of the 2020'ies, the new LRF must be set much higher than the proposed 4.2 % to reach the EU -55 % climate target.

The intake rate of the MSR should be kept at 24 % also beyond 2023 and the thresholds for when the MSR is activated should be lowered

Introduced in 2019, **the Market Stability Reserve (MSR) is instrumental** in addressing the EU ETS market surplus that has accumulated since Phase 2 (2008-2012). The MSR combined with the rule-based invalidation of the most excessive surplus as in the MSR from 2023 are among the main reasons for the strengthening of the EU ETS market price since 2018.

According to the current EU ETS Directive, the “intake rate” of the MSR is set to retreat back from today’s 24 % to 12 % after 2023. There is an obvious risk that this would seriously weaken its ability to handle market disruptions in the future and hence that it could result in a much lower EUA market price at times. Therefore, it is important to ensure **a continuation of today’s 24 % intake rate** (at least) also beyond 2023, as also reflected in the Commission’s proposal.

The other very important aspect of the MSR review is **the need to adjust the pre-defined thresholds** for when the MSR shall be activated. The current thresholds were defined in 2015 based on an estimation of the hedging needs by that time. Today, it is clear that especially the upper threshold needs to be reduced, from 833 to around 500-600 M EUAs, to reflect a more decarbonised economy and lower hedging needs the power sector in particular. The Impact Assessment¹ by the Commission also describes how the total hedging in the market reduces.

Hence, **we question why the Commission did not include a lowering of the MSR’s upper activation threshold (833 M EUAs) in its legislative proposal**. The idea of a more dynamic MSR intake rate, in the 833-1,096 TNAC interval (‘buffer zone’), could indeed have its benefits. But without a simultaneous lowering of the 883 threshold, it will lead to a less ambitious MSR mechanism, everything else equal, allowing more unused EUAs in circulation in the market.

The rule-based permanent invalidation of the most excessive EUA surplus that is being placed into the MSR needs to be maintained

As a result of the large market surplus, the amount of EUAs that is going into the MSR is very substantial. In the latest revision of the EU ETS Directive, it was agreed that **the most excessive holdings of the MSR should be permanently cancelled (invalidated)**, while keeping a volume that can be used to further supply the ETS market with additional EUAs, if there is too much scarcity. This provision remains essential and **it should be ensured that it continues to apply in the EU ETS Directive**. It secures long-term scarcity and avoids that the surplus of EUAs returns to the market later, which could again lead to lower CO2 prices and increased CO2 emissions. **Vattenfall supports the European Commission’s proposal to keep the invalidation rule**, while changing the number of allowances that are kept in the MSR to 400 M EUAs, instead of the amount of allowances auctioned in the previous year.

Adjusting the ETS allowance supply in response to overlapping policies should be done more directly, predictably and mandatory

Vattenfall believes that **the supply of ETS allowances should be directly adjusted** by an amount corresponding to the CO2 emissions that are reduced by overlapping national policies. The MSR has a certain ability to address ETS market distortions, but it will unlikely be sufficient to address the large over-supply that could be the result of a nationally regulated phase-out of coal-fired power. Also it is illogical that Member States continue to supply (auction) the same amount of EUAs to the EU ETS market when they at the same time put in place strong national policies to reduce the domestic CO2 emissions from the power sector. The EU ETS Directive already provides for Member States to voluntarily withhold allowances, though **it should be considered how this adjustment can be done more directly, predictably and mandatory**. To avoid creating an economic disadvantage for Member States that want to pursue more ambitious policy, it could also be considered to make the ETS cap adjustment on the EU level.

¹ European Commission, Impact Assessment Report, SWD(2021) 601 final, Part 3/4, page 58-59

The scope of the EU ETS should be expanded to more GHG emission sources, although not every sector is suited for a direct inclusion

In principle, the EU ETS should be expanded to cover as many sectors in the economy as possible. However, the priority should be on sectors which are currently not exposed to any CO₂ price (e.g. maritime) or (in some Member States) an insufficient CO₂ price (e.g. individual heating in buildings). **The road transport sector, on the other hand, is unlikely to be suited for a direct inclusion in the EU ETS.** For that reason, Vattenfall supports the Commission's approach to **include the shipping sector in the existing EU ETS** while at the same time establish a **new and separate ETS for the buildings and road transport sectors**. However, the new separate ETS for the building and transport sectors should be entirely parallel and **not lead to any double CO₂ pricing** for installations already covered by the existing EU ETS.

The EU ETS should treat all means of CO₂ transport equally and negative CO₂ emission technologies should be better promoted

Vattenfall agrees with the Commission's proposal that **all means of CO₂ transportation** to the storage site should be recognised when reducing emissions by Carbon Capture and Storage (CCS). The current legislation is merely referring to pipelines, hence it omits transport by e.g. sea, road and rail. It is also important that the obligation to surrender EUAs is removed when emissions are reduced by Carbon Capture and Utilisation (CCU). It is if and where the CO₂ is finally emitted to the atmosphere that the obligation to surrender EUAs should be arise.

By using Biomass-CCS (BECCS), an installation that has phased out all its fossil fuels can still make a very important contribution to the society reaching the 'net-zero' GHG emissions goal. Thus it should be considered how **BECCS technology should be better promoted**, bearing in mind that the EU ETS gives no incentives to reduce CO₂ emissions below zero at present.

The free allocation should be fuel-independent and units that reduce emissions by using biomass should not be removed from the EU ETS

As long as there is free allocation in the EU ETS, it is important to pay attention to the incentives that it comes with it, beyond the CO₂ price that should always be the main driver. We therefore support the Commission's proposal to **ensure that the free allocation regime does not discourage investments in new break-through technologies**, such as fossil-free steel production. This is achieved e.g. by making the EU ETS benchmarking approach independent of processes and fuels, and by instead pursuing the '*one product, one benchmark*' principle.

For the same reason, **we do not agree with the Commission's proposal** to exclude certain combustion installations from the EU ETS just because they have switched to using **a certain share of biomass ('95 % rule')**. Removing an installation from the EU ETS because it has switched from a fossil fuel to biomass could become a counter-productive incentive in relation to what the EU ETS intends to achieve. Heating installations often have the possibility to switch fuels without any technical adaptations. It could also be very disruptive for companies and authorities if an installation moves in and out from the scope of the EU ETS depending on which fuel mix it is using at a certain time. It is welcome, though, that the Commission wants to ensure that **CHP plants in district heating** are treated equally with industrial cogeneration.

The Innovation Fund should be strengthened by setting aside a larger share of ETS allowances used for mobilising the financing

The EU Innovation Fund plays a key role in supporting immature low-carbon technologies before they become commercially available. Vattenfall supports the Commission's proposal to **strengthen this funding instrument** by setting aside a larger share of the ETS cap. What is also positive is that **Carbon Contracts for Difference (CCfD)** are recognised as an efficient tool to provide an additional technology support that can work well together with the EU ETS.