Vattenfall's views on the EU ETS post-2030 reform

Policy Paper

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At Vattenfall, we are committed to building a future where everyone can choose fossil-free ways to move, make and live. To safeguard and strengthen EU competitiveness and energy security, whilst delivering on the EU's goal to become a climate neutral economy by 2050, it is paramount to bring the European Green Deal to life. This can be achieved by a swift national implementation of the newly updated EU 2030 energy and climate policy framework, including the latest revision of the ETS Directive (Directive (EU) 2023/959), while also paving the way for new EU climate ambitions for 2040. To speed up the transition, for the benefit of both climate and energy security, it is key to ensure that the recently agreed regulatory frameworks are timely and effectively enforced, thereby incentivizing the necessary investments in a fossil-free future.

KEY MESSAGES

- It is paramount to bring the European Green Deal to life by a swift national implementation of the EU decisions in the Fit for 55 package, including the latest revision of the EU Emissions Trading System (EU ETS) Directive adopted in 2022.

- Vattenfall fully supports the European Commission's recommendation for an EU climate target of at least -90 % net-reduction of the GHG emissions by 2040 relative to 1990, as required by science to align with the global 1.5 °C goal.

- It is essential to maintain the EU ETS as a fundamental mechanism for achieving decarbonisation of the EU economy through market-based and cost-efficient means. A new revision of the directive is needed to ensure its effectiveness beyond 2030 and deliver on the new EU 2040 climate ambition.

- A fair distribution of mitigation efforts across sectors is needed, both through the ETS cap-setting and policies in non-ETS sectors. All sectors must contribute to the EU's climate goals and receive stronger incentives to phase out fossil fuels.

- Carbon removals (CDR) should be incorporated into the EU post-2030 climate policy framework. Emphasis should be placed on technology-based CDR, and permanent CDR credits approved by the EU's new Carbon Removal Certification Framework (CRCF) should be permitted in the EU ETS.

- The Market Stability Reserve (MSR) design parameters need to be updated to remain effective post-2030, particularly regarding the activation thresholds.

- It is important to protect the EU ETS from unintended impacts of overlapping policies at both the EU and national levels. To maintain confidence in the EU ETS policy, it is absolutely essential to avoid further ad-hoc interventions in the EUA supply.

- A fully EU-harmonised approach on municipal waste installations in the EU ETS is necessary. Additionally, addressing GHG emissions from landfills is crucial to contribute to the EU climate target and prevent CO2 leakage from the ETS.

- The EU ETS should be linked with other carbon markets, including the UK ETS, promptly. International credits from the new Paris Agreement Crediting Mechanism, may also be included, although only in the form of permanent carbon removals.

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DETAILED POLICY POSITION

Vattenfall is working for fossil freedom and have set science-based corporate targets to reduce its GHG emissions by 77% by 2030 and achieve net-zero emissions by 2040. In June 2023, SBTi approved our 1.5°C-aligned 2040 targets, which are aimed at cutting the scope 1 and 2 GHG emissions by 91.7% per kWh and scope 3 emissions by 90%, compared to 2017 levels.[1]

Vattenfall fully supports the European Commission's recommendation for an EU climate target of at least -90 % reduction of the net-GHG emissions by 2040

After the adoption of several key EU climate laws in the 'Fit for 55' package, it is now crucial to implement these decisions fully to meet the EU's 2030 targets and at the same time extend the policy making focus to 2040. By 2025, the EU and all other Paris Agreement signatories must submit new Nationally Determined Contributions (NDCs) with post-2030 climate targets. Currently, the EU lacks a 2040 climate target, unlike many Member States and companies. Setting an ambitious EU 2040 target, in line with the European Commission's proposal on a 90 % reduction of the net-GHG emissions by 2040 relative to 1990, will enhance the visibility of the EU's decarbonisation path, boost investor confidence, provide economic opportunities, and improve the EU's security of supply. In our view, the EU objectives of decarbonisation and competitiveness go hand in hand, which should also be reflected in the EU clean industrial deal to be developed in 2025.

It is absolutely essential to maintain the EU ETS as a fundamental mechanism for decarbonising the EU economy through market-based and cost-efficient means

Vattenfall strongly supports the EU ETS policy as a centre-pillar of the EU climate policy framework. We believe the EU ETS should be the main driver to achieve the EU climate targets in covered sectors. Recent revisions have strengthened, broadened and improved the functioning of the EU ETS policy, and the uniform CO_2 price across the EU has helped to drive down emissions for example by phasing out coal from the electricity production.

A continued rapid decarbonisation of the EU power sector is essential, but it is also very important that all the new fossil-free capacity replaces fossil fuels in other sectors like transport, industry, and buildings. Unfortunately, Europe's electrification pace lags behind what is needed to meet the EU climate targets. Electricity demand should rise in all sectors, however it is currently declining[2][3] . Setting an ambitious EU-wide 2040 climate target and expanding the use of CO_2 pricing are a part of the solution to this. In addition, we need a comprehensive approach that creates demand for fossil-free products across the entire value chains.

The EU ETS also generates very substantial auction revenues which should be used to a greater extent for supporting breakthrough technologies, increasing the electrification and compensating vulnerable groups who also need to be a part of a just transition.

An update of the EU ETS directive is needed in order to make sure the EU ETS is fit for purpose also post-2030

Reaching climate-neutrality (net-zero GHG emissions) in the EU economy by 2050 will not be possible without very steep emission reductions in all sectors. The EU should continue to expand the use of CO_2 pricing, while also completely evacuating any risk of carbon leakage between different sectors as well as out from the EU.

Vattenfall welcomes the already agreed introduction of a new ETS for emissions from the road transport and buildings sectors (ETS2) as from 2027. Provided that ETS2 functions as intended, the Effort sharing Regulation (ESR) may become more or less redundant after 2030, since double-regulating the same CO_2 emissions under a binding and absolute ETS cap would counteract the cap-and-trade principle and reduce the overall socio-economic benefits.

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1 See details on targets for specific Scope 3 categories on the SBTi website, Vattenfall website or Vattenfall annual report
2 https://climate.ec.europa.eu/eu-action/climate-strategies-targets/2040-climate-target_en
3 https://www.eurelectric.org/publications/decarbonisation-speedways-full-report/

The Linear Reduction Factor (LRF) should remain at its current level beyond 2030, for the sake of regulatory stability and considering that it is already set on an ambitious level as it proceeds towards 2040. In the latest revision of the EU ETS Directive revision, it was agreed to set the LRF at 4.3% from 2024 and 4.4% from 2028 onward. It means that the ETS1 allowance cap reaches zero by 2039, after which no further EUAs will be issued. This long-term visibility of the ETS allowance cap trajectory is a major advantage of the EU ETS policy compared to other policy instruments. It helps companies in the EU ETS and investors in general to make projections and develop their decarbonisation strategies.

Although the EUA supply decline to zero by 2039, it should still be possible for industries with hard-to-abate emissions to release some CO_2 emissions in the 2040'ies and towards the EU's net-zero goal. It can be done by e.g. allowing EU ETS operators to use high-quality carbon removal credits from the new EU CRCF subject to restrictions and limited to CDR credits from projects with permanent CO_2 storage. This will have the dual benefit of allowing certain hard-to-abate emissions to still be released after 2039, without jeopardizing neither the 2040 nor 2050 climate target, and at the same time support new investments in the technology-based carbon removals.

Carbon removals should be integral to the EU's post-2030 climate policy framework and EU ETS operators should be able to use permanent CDR credits

Vattenfall fully supports the EU ETS Directive's request for the European Commission to investigate and present by 2026 how carbon removals could be covered by emissions trading. We welcome the intention already enshrined in the Directive (Art 30(5)) that it will be limited to permanent carbon removals, i.e. Bio-energy carbon capture and storage (BECCS) and capture of CO_2 emissions directly from the atmosphere (DACCS), while fully maintaining the incentive to phase out fossil fuels in the EU ETS installations.

Technology-based (industrial) carbon removals are indeed the most safe, reliable and permanent Carbon Removal category, but they are also the most expensive at present. Over time, costs may decrease while EUA supply becomes scarcer or even exhausted, potentially narrowing the gap between EUA prices and CDR abatement costs. However, if the EU ETS does not drive significant demand for technology-based CDR credits in the short and medium term, due to the relatively high price, additional policies will be required to support the permanent carbon removal solutions that will be needed to reach the EU's net-zero goal for 2050.

The design parameters of the Market Stability Reserve (MSR) must be updated to ensure the mechanism is fit for purpose also under post-2030 market conditions

The MSR tool's continued success depends on setting policy design parameters for the post-2030 EU ETS market. During the 2021-2022 EU ETS directive revision, Vattenfall called for adjusting the activation thresholds to reflect a more decarbonised economy and lower EUA hedging needs. Despite this, the upper threshold of 883 $MtCO_2$ remained and a new buffer zone in the TNAC range of 833-1,096 $MtCO_2$ was added to reduce volatility, although with the side-effect that it led to an increased surplus EUAs being allowed in the market. Therefore, adjusting the MSR's activation thresholds is now even more essential to keep its ability for handling severe disruptions in the EU ETS market also after 2030.

The EU ETS should be protected against unintended effects of overlapping policies and ad-hoc interventions must be avoided to keep the confidence in the EU ETS

The EU ETS is still suffering from a loss of confidence due to the 2022 ad-hoc policy intervention aimed at mobilizing €20 billion for the RePowerEU plan. This intervention has increased the EUA supply in the auctions until 2026, thereby weakening short-term prices but potentially raising them further in 2027-2030 when the supply is constrained with the same amount. The more lasting impact is the regulatory uncertainty it created among traders and investors, who fear future interventions of a similar kind. Vattenfall has been critical of the EU ETS policy's use in the RePowerEU context, particularly the Commission's original proposal to take surplus from the MSR. To bolster the EU ETS in the future, we also believe that Article 12(4) of the ETS Directive should become mandatory for all Member States rather than voluntary. Article 12(4) gives Member States the possibility to cancel EUAs associated with the closure of fossil fuel based generation capacity due to national policies. To ensure that such policy measures have an impact on the global emissions it must be coupled with adjusting the ETS cap.

A fully EU-harmonised approach on municipal waste installations is necessary and GHG emissions from landfills must also be addressed to avoid carbon leakage

A unified EU approach to municipal waste incineration plants from 2028 is essential for creating a level playing field in the internal market, as it is only a few Member States that have included it before. Expanding the EU ETS to waste incineration may however lead to leakage and increased landfill use, thereby causing more methane emissions and other environmental problems. Therefore, we believe that the EU's current ambition to reduce the amount of waste that is put on landfills (10 % by 2035) should be further accelerated and that a landfill ban could be more appropriate than including landfills in the EU ETS.

Vattenfall also calls for the European Commission to investigate whether ETS2 could be a more suitable policy tool for municipal waste incineration plants than ETS 1, considering that it builds upon an upstream approach. In fact, owners of waste incineration plants cannot control how much fossil-based plastic households put in their waste. So while CCS may be the only plant-level solution to address these CO_2 emissions, stronger incentives for plastic sorting and recycling must be targeted at the upstream actors.

Linking of EU ETS towards other carbon markets, incl. UK ETS, should be pursued and international credits may be considered for inclusion under certain conditions.

Vattenfall supports expanding CO_2 pricing and linking carbon markets more globally. This involves linking the EU ETS with other mandatory ETS such as the UK ETS, as well as integrating certain emissions credit types from the Paris Agreement Crediting Mechanism (Article 6.4) and more specifically carbon removals that lead to a permanent CO_2 storage.

Linking the EU ETS and UK ETS should be prioritized due to their similar design and shared history pre-Brexit. As market liquidity decreases with declining allowance caps, merging them becomes increasingly beneficial. Additionally, linking these markets would ease difficulties related to the Carbon Border Adjustment Mechanism (CBAM) faced by companies on both sides.

The global carbon market created by Article 6 of the Paris Agreement offers interesting opportunities. Credits from the Paris Agreement Crediting Mechanism can be included in the EU ETS on the condition that they are CDR credits with permanent CO_2 storage. New credits must uphold EU ETS integrity and continue fostering the phase-out of fossil fuels.

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