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

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- Vattenfall welcomes the adoption by the European Council of an ambitious EU 2030 climate target of 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 prepared, agreed and put into force as soon as possible**, so that all part of the society can contribute to deliver these GHG emission reductions cost-efficiently and timely in the short timeframe that remains to 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 measures that can improve the system.

- **A higher Linear Reduction Factor (LRF) should be adopted.** It is absolutely essential that the new LRF is set to **take effect already from 2023**, or 2024 at latest. **A distinct rebasing of the ETS cap,** reflecting today's lower CO2 emissions baseline, is also a viable option for setting the ETS allowance trajectory on the right course early.

- It is important to ensure that the **Market Stability Reserve (MSR)** continues to have a strong ability to tackle exceptional events in the future. Hence some of its 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 for ensuring 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** on the EU and national level. In that context, it should be considered if the withholding of EUA supply linked to national policy measures in the power sector, as provided by Article 12(4), can be made more direct, predictable and mandatory.

- **The EU ETS should be expanded to other sectors and regions** where it is appropriate. Priority should be given to sectors such as maritime and buildings. However, the **road transport sector is not suited** for a direct inclusion into the existing EU ETS, and therefore the option of setting up a separate ETS or other forms of CO2 pricing should be considered.

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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 December 2020, the EU leaders unanimously endorsed a revision of the EU's 2030 climate target from -40 % to at least -55 % net GHG emissions reductions by 2030 (vs. 1990) in the European Council. Now, it is **important that the EU 2030 climate and energy policy framework is swiftly updated** to steer towards the agreed new climate ambitions, especially the EU ETS Directive and the EU Effort Sharing Regulation (ESR), which cover around ½ of the EU's total GHG emissions each. The additional effort of reducing GHG emissions that comes with the increased EU 2030 and 2050 climate ambition should be fairly and cost-efficiently distributed between the sectors regulated by the EU ETS policy and the sectors which are instead 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 strongly believes that the EU ETS should be the principal instrument to achieve the EU's climate targets with regards to the sectors that are covered by this policy. As a result of the latest revision of the EU ETS Directive agreed in 2017, the system has been significantly improved and induced a CO2 price that has clearly contributed to the phase-out of coal from the EU's power market. In the turbulent market situation caused by the Covid-19 pandemic that started in 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 bloc'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 and 2050 climate targets more balanced and cost-effective.

The new Linear Reduction Factor (LRF) should take effect 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. Following a legislative proposal from the European Commission in June 2021, a realistic and desirable start date of a new LRF would be 1 January 2023. Next to the start date, the actual level of the updated LRF is also highly dependent on whether a 'rebasing' of the ETS allowance cap is made during the course of Phase 4 (2021-2030).

A rebasing of the ETS cap would make the trajectory better reflect the CO2 emission reductions achieved in the more recent years

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. Instead it is the MSR that has mostly contributed to a scarcity of ETS allowances. Therefore we believe that **it is advisable to make a one-time reduction (rebasing) of the ETS baseline** to ensure that the overall ETS allowance cap better reflects the actual emissions. Without a rebasing in the first half of the 2020'ies, the new LRF must be set much higher to reach the (ETS share of) the EU -55 % climate target in Phase 4.

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. The MSR, together with the rule-based cancelling of the most excessive surplus in the MSR from 2023, is the main reason for the strengthening of the EU ETS market price in 2018-2019. During the shock resulting from the Covid-19 pandemic in 2020, the benefits of the MSR have become even more obvious.

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 will seriously weaken its ability to handle market disruptions in the future and that it will result in a much lower EUA market price at times. Therefore, the review of the MSR that is now embedded in the EU ETS reform should lead to **a continuation of today's 24 % intake rate** (at least) also beyond 2023.

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 of 833 M EUAs (over which 12/24 % of the surplus is transferred to the MSR each year) and 400 M EUAs (under which 100 M EUAs is returned to the market from the MSR), 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 gradually more decarbonised economy and lower hedging needs in the power sector in particular.

The rule-based permanent cancellation of the most excessive EUA surplus accumulating in the MSR needs to be maintained ahead

As a result of the large surplus of EUAs that emerged from Phase 2, the amount of EUAs going into the MSR is 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. More specifically, all EUAs kept in the MSR above the amount of auctioned EUAs in the previous year shall be invalidated from 2024. 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.

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

The MSR has a certain ability to address ETS market distortions and withhold allowances when the demand suddenly drops. But the MSR will not be sufficient to address the large over-supply that could be the result of a strong policy driven phase-out of coal-fired power in the coming decades. Also it is not logical that Member States continue to supply (auction) the same amount of EUAs into 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. Therefore, it is important that **the supply of ETS allowances should be directly adjusted** by an amount corresponding to the CO2 emissions that are reduced by the national policy measure.

According to Article 12(4) of the EU ETS Directive, Member States have already a possibility to withhold ETS allowances in respect of the CO2 emission reductions linked to national measures to close down fossil fuel based electricity production in their territory. In the next revision of the EU ETS Directive **it should be considered how this adjustment of the ETS supply can be done more directly, predictably and mandatory**. To not create an economic disadvantage for the Member States that want to pursue a more ambitious climate agenda, it could also be considered to make the ETS cap adjustment on the EU level.

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

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**, considering the already existing policies in that sector and the potential risk of undesired effects with regards to sectors already included in the EU ETS. An alternative to placing new sectors into the EU ETS is to establish a separate system which can avoid some of the politically undesired effects on the EU ETS market and already included sectors. At the end of the day, what is most important is that all sectors and all GHG emission sources in the economy are subject to an adequate CO2 pricing incentive.

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

When an operator uses Carbon Capture and Storage (CCS) technology to reduce its CO2 emissions, then the CO2 emissions should not be counted as emitted and the ETS operator should not have to surrender ETS allowances for this part. This is how the EU ETS Directive is already intended to function. However, both the EU ETS Directive (Annex 1) and the Monitoring and Reporting Regulation (Article 3) explicitly refer to transport of CO2 “by pipelines” between the separation site and the storage site. This limitation in terms of the CO2 transportation mode should be revised with a view to **expand the scope defined in the legislation to transport by sea, road and rail**, basically all safe forms of CO2 transportation.

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.

Combustion installations that have reduced CO2 emissions by using biomass should not be removed from the scope of the EU ETS

Since 2009, the EU ETS directive (Annex 1) states that installations exclusively using biomass should not be covered by the directive. The intention is good if it reduces the administrative burden, but unfortunately it can also lead to undesired consequences. For example, 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.

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. To accelerate the development of new innovative low-carbon technologies in the energy and industry sectors, the volume of EUAs that is set aside for this purpose should be increased. The EU Innovation Fund could also be developed to focus more specifically on key technologies such as Biomass-CCS (BECCS) that can contribute with the negative CO2 emissions that will be needed for reaching ‘net-zero’ GHG emissions by the mid-century, on top of the strong focus needed for phasing out all fossil fuels.