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UFE's position paper on the Emission Trading System (ETS) and carbon offset schemes

The European Union has set a very high ambition for decarbonising its economy, with a goal of achieving carbon neutrality by 2050 and reducing greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels. **UFE firmly supports these two objectives, which are consistent with scientists' recommendations to limit climate change**.

Achieving them requires drastically reducing CO_2 emissions in all sectors, in particular those covered by the ETS (currently the electricity sector and a part of the industry in ETS 1, and in the future, buildings, road transport, and other sectors in ETS 2). The ETS explicitly prices the negative externality of CO_2 emissions, enabling the most cost-effective investments in emission reduction. This approach is particularly relevant as climate targets may become more ambitious. Given the substantial macroeconomic costs of the transition, optimising expenditure remains a top priority.

1) Conduct an ambitious revision of the ETS framework following its review by the Commission to ensure decarbonisation incentives are in line with the GHG emission reduction objective

In the long term, decarbonisation targets are becoming even more ambitious, and the price of CO_2 will need to consistently follow an upward trend. **The Commission released a communication in February 2024 based on its impact assessment on the pathways to achieve the goal of carbon neutrality by 2050. It recommends a net reduction of greenhouse gas emissions of 90% by 2040. In this context, optimising public policy instruments is essential to minimise the cost of the transition**. Indeed, the overall cost of the transition is very sensitive to the policy mix of the instruments used to implement the more efficient decarbonisation actions. Given the already high costs of the transition, a suboptimal choice of policy mix could jeopardise its success and severely undermine its social acceptability, which directly depends on the cost borne by the economy.

More concretely, to minimise the overall cost of decarbonisation by 2040, **it is necessary to assign a high enough price signal to CO_2 emissions in sectors where the decarbonised technologies are sufficiently mature and accessible to replace current uses**. Reducing emissions by 90% by 2040 compared to 1990 is only feasible if CO_2 prices are incentivising enough in the sectors where substitutions are desired by that horizon.

Considering the varying abatement costs of different technologies, these CO_2 price levels would enable the implementation of the following priority decarbonisation actions by making them economically viable:

1. **Completing the decarbonisation of the electricity sector** by excluding carbon-based electricity production methods and by investing in current and new low-carbon thermal capacities for peak demand,
2. **Electrifying end-use applications** by accelerating the electrification of road transport and deploying heat pumps for building heating,
3. **Decarbonising the industry** by deploying high-temperature heat pumps and electric boilers and by developing non-electric decarbonisation technologies (including CCUS and renewable heat).

If a highly ambitious target, such as a 90% reduction, were to be adopted with a sub-optimised policy mix based on standards and quantitative targets other than the CO_2, the cost of the transition would increase very significantly, making a political and social rejection of the transition very likely.

Therefore, UFE calls for an ambitious revision of the ETS framework following its review by the European Commission to ensure that sufficiently robust and efficient decarbonisation incentives are sent to all sectors in order to achieve the 2040 GHG emission reduction targets at the lowest cost. In this context, UFE calls for long-term visibility on CO_2 prices and for price levels to be consistent with climate trajectories.

A floor price could be a valuable tool, giving stability and predictability. The floor price of the ETS 1 quota could be set based on historical prices (so that it is only triggered if the CO_2 price falls below levels where the industry is no longer incentivised to invest in decarbonisation technologies) and would gradually increase in line with the EU's climate ambitions. This would allow the ETS to continue functioning as a market-based instrument, but with visibility on a clear minimum trajectory for the CO_2 price that will be necessary to achieve the EU's climate goals.

Therefore, UFE supports the implementation of a floor price for the ETS 1 carbon quota as described above, which would increase linearly over time to provide the carbon quota price with a long-term predictable trajectory. UFE calls for a carbon floor price for ETS 1 starting at €60/tCO2 and increasing over time, thus providing investors with visibility to trigger investments in decarbonisation.

Regarding ETS 2, a similar approach could eventually be appropriate with the aim of achieving convergence between the two ETS. However, given the gradual and cautious implementation of ETS 2, which will come into effective operation in 2027, the implementation of a floor should only be considered after feedback from the initial periods. **Moreover, UFE emphasises that a merger between the two ETS can only take place if the impact of ETS 2 on the reduction of emissions in the covered sectors is clearly demonstrated and if the price levels of the two systems converge**.

In the absence of a floor on the price of the ETS 1, the carbon price signal could also be improved by a **reform of the Market Stability Reserve (MSR)**, initially implemented by Decision 2015/1814 of October 6, 2015. This mechanism was created to adjust the supply of quotas on the EU ETS market in case of a supply/demand imbalance. Today, the MSR operates as follows: if the volume of quotas in circulation is above 1096 Mt, 24% are placed in the reserve; if it is between 1096 and 833 Mt, the difference is placed in the reserve; below 400 Mt, 100 Mt are injected from the reserve into the market.

While the MSR notably adjusted the supply of quotas during the Covid crisis (as the decline in industrial activity abruptly reduced the demand for quotas), it enabled a more flexible and resilient mechanism in the event of macroeconomic shocks. However, several aspects can still be improved.

First of all, the MSR is triggered based on the calculation of the total number of allowances in circulation in the market, the TNAC (Total Number of Allowances in Circulation). The TNAC is calculated once a year based on the emission data from the previous year, which introduces a time lag between the adjustment of the volume of quotas auctioned and the current market fundamentals. Therefore, the TNAC does not represent market equilibrium; it only provides a past view of the system's supply/demand balance. The European Commission collects and verifies the emission levels of companies subject to the ETS during the first half of the current year. The adjustments resulting from the calculation of the TNAC are only known in the second half of the year, which explains a delayed reaction from the MSR. **This time lag makes the MSR regulation very slow to react to sudden shocks, such as an economic crisis or significant market fluctuations**. Moreover, the mechanism has a counterintuitive effect on economic agents. If an actor anticipates high quota prices in the coming years, he is encouraged to store the quotas he already has and initiate decarbonization efforts. However, the banking of quotas will have the effect of increasing the TNAC, which leads to the MSR absorbing more quotas, thus restricting supply and creating a risk of price surge in the market.

To address these issues, **reviewing the MSR activation criteria by setting high and low-price thresholds could be a potential solution**. These thresholds would follow a defined upward trajectory and enable the adjustment of the auction schedule according to a predefined framework, providing market participants with a more dynamic perspective than the current system. **Therefore, the MSR activation criteria would no longer be subject to the drawbacks related to the TNAC and would allow the MSR to be more dynamic while providing better visibility of the ETS price to economic agents**. The functioning of the MSR would remain the same: below the floor price, it would absorb quotas, and if the price of a ton of carbon is above the ceiling price of the reserve, it would inject quotas into the market. This solution would allow more frequent adjustments, thus resulting in a more resilient ETS.

Therefore, UFE calls for a discussion on the triggering criteria of the MSR. The MSR could thus be activated based on price criteria to allow for a more reactive adjustment of the permit supply according to high and low carbon price levels. These increasing levels would be defined in advance to help drive the price between these two values, thus reducing the uncertainty on investments while maintaining a clear visibility on a reduction trajectory.

Furthermore, considering the interactions between the European carbon market and other energy-climate policy instruments, such as subsidies, environmental standards, and sectoral regulations, is crucial for achieving climate objectives in the most effective and coherent manner.

Reducing emissions must remain the absolute political priority. Nevertheless, carbon dioxide removal (CDR) projects are subject to rigorous monitoring, and their associated risks are carefully managed and considered. Therefore, **UFE recommends that the European Commission adopt a cautious approach, based on an impact assessment, to begin integrating CDR into the EU-ETS to offset emissions from hard-to-abate sectors**. This integration would maximise the use of different decarbonisation technologies and could help reduce the costs of the transition to a zero-carbon economy. As a first step, only high-quality technological CDR projects certified under the CRCF Regulation should be integrated.

While ensuring the avoidance of double counting, it is also necessary to quickly establish robust rules for the accounting of emissions in the EU-ETS for the CCU value chain. Stakeholders in the CCU value chain need a clear, stable, and predictable regulatory framework for the treatment of captured and reused CO_2 to enable investments.

Decarbonisation technologies being very capital-intensive, some economic actors may be reluctant to initiate these investments, particularly given the **volatility of the quota price**. For the most capital-intensive investments, it is therefore necessary to protect economic actors from a drop in the CO_2 price. Carbon contracts for difference (CCfD), similarly to contracts for difference on electricity, help prevent CO_2 price volatility. **It is thus an additional tool in the array of solutions available for reaching decarbonisation**. Given that CCfDs can be significantly costly for member states, it is essential to build a robust regulatory framework, particularly with the approval of the European Commission. Finally, since CCfDs lead to a reduction in emissions regardless of the ETS price, their implementation could lead to negative interactions with the carbon market. **It will therefore be necessary to implement measures to limit the impacts of CCfDs on the supply/demand balance of ETS 1**.

The acceleration of the energy transition, even based on a strong CO_2 price signal, will lead to a heterogeneous distribution of costs among the different actors. It will therefore be increasingly crucial to rely on robust and **well-targeted redistribution mechanisms**:

- To ensure that the cost of the transition does not burden the **most vulnerable households**;
- To fairly calibrate this cost allocation with other public policy objectives, like maintaining companies' competitiveness, particularly with the distortions incurred by unfair competition, and **maintaining an industrial base for sovereignty purposes**.

It will therefore be necessary to quickly remodel the tool for compensating the indirect costs of the EU-ETS to defend the international competitiveness of European industry.

2) Review the guidelines of carbon offset schemes to enhance the international competitiveness of European industry

The offset of indirect costs of the EU-ETS allows member states to offset part of the ETS costs internalised in the wholesale electricity prices for energy-intensive industrial consumers in sectors exposed to international competition and carbon leakage (aluminum, hydrogen, fertilisers, steel, paper, copper, etc.). It takes the form of aid provided by the Member States: each State can invest, without justification, up to 25% of the revenue it derives from ETS auctions and compensate up to 75% of the identified costs.

The aid allocated under the carbon offset scheme depends on an emission factor (the higher the emission factor, the greater the aid) which is currently differentiated by member state or geographical area. This emission factor represents the carbon content in the price of electricity. **The method for calculating emission factors must better reflect the impact of the CO_2 price on the electricity price**. It is calculated in two ways according to a methodology defined in the guidelines on state aid in the context of the EU ETS:

1. **By default**, it is the result of "*the division of the CO_2 emission data of the electricity sector by the gross electricity generation based on fossil fuels in the relevant geographic area"*.

This method has several limitations:

- On the one hand, it focuses on the volume of electricity produced by the fossil capacities of a mix (even if these are not marginal). However, the final price paid by the industries is the key factor and it is marginal technology that determines this price;
- On the other hand, it tends to overlook the fact that the coupling of European markets leads to a common electricity price for all interconnected countries as long as the interconnection capacities are not saturated.

The default method thus leads to differentiated emission factors and subsidies according to European countries that do not accurately reflect the relative cost increase of the ETS in wholesale electricity prices.

2. The guidelines also provide for the possibility for member states to make a counterproposal after a negotiation with the European Commission with a **market-based emission factor**: it is established "*based on a study of the CO_2 content of the actual margin setting technology in the electricity market.*"

The guidelines of carbon offsetting for the period 2021-2030 must be revised in 2025 to update, if and when necessary, the benchmarks for electricity consumption efficiency, geographical areas, and CO_2 emission factors.

The upcoming revision of the guidelines represents an opportunity to review the carbon offset schemes, to strengthen Europe's role as a global leader in the green industry. Therefore, UFE calls on the European Commission to consider the opportunity to improve the methods for calculating the emission factor in order to better reflect the additional cost related to the ETS paid by consumers in wholesale electricity prices.

Moreover, **the price divergence criterion for the regionalised calculation of emission factors deserves re-examination to better take into account the reality of market coupling and the evolution of current electricity production mixes**. As member states complete the decarbonisation of their electricity production mix, SPOT prices should experience significant volatility, reflecting the reality of the European electricity system, particularly with the historic deployment of renewable energies.

At the same time, UFE stresses the importance of complementarity between the ETS and the CBAM. These two mechanisms play a key role in effectively reducing emissions and preventing carbon leakage. However, given the current scope of the CBAM, UFE emphasises that it does not fully protect downstream sectors of the value chain, especially those vulnerable to carbon leakage for exports. UFE considers that including other sectors and products identified as at risk is crucial to ensure the international competitiveness of European industry.

The feedback of the transitional phase of the CBAM (2023-2025) will ensure a more precise analysis of the mechanism's effects on European industry. The results will provide an opportunity to expand the mechanism to other sectors exposed to carbon leakage risks, as well as assessing the relevance of including

indirect emissions for all concerned sectors.