

Accelerating market-led decarbonisation through the EU ETS reform

A Eurelectric reaction paper to the EU ETS revision
proposal of the Fit for 55 package

Eurelectric represents the interests of the electricity industry in Europe. Our work covers all major issues affecting our sector. Our members represent the electricity industry in over 30 European countries.

We cover the entire industry from electricity generation and markets to distribution networks and customer issues. We also have affiliates active on several other continents and business associates from a wide variety of sectors with a direct interest in the electricity industry.

We stand for

The vision of the European power sector is to enable and sustain:

- A vibrant competitive European economy, reliably powered by clean, carbon-neutral energy
- A smart, energy efficient and truly sustainable society for all citizens of Europe

We are committed to lead a cost-effective energy transition by:

investing in clean power generation and transition-enabling solutions, to reduce emissions and actively pursue efforts to become carbon-neutral well before mid-century, taking into account different starting points and commercial availability of key transition technologies;

transforming the energy system to make it more responsive, resilient and efficient. This includes increased use of renewable energy, digitalisation, demand side response and reinforcement of grids so they can function as platforms and enablers for customers, cities and communities;

accelerating the energy transition in other economic sectors by offering competitive electricity as a transformation tool for transport, heating and industry;

embedding sustainability in all parts of our value chain and take measures to support the transformation of existing assets towards a zero carbon society;

innovating to discover the cutting-edge business models and develop the breakthrough technologies that are indispensable to allow our industry to lead this transition.

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KEY MESSAGES

- **Increase the ambition in the EU ETS.** We welcome several of the Commission's proposals to strengthen the EU ETS in line with the increased 2030 climate target, including the increased linear reduction factor (LRF) to 4.2% in combination with a one-off reduction of 117 million allowances as of 1 January 2024. We also welcome keeping the Market Stability Reserve (MSR) intake rate at 24% and increasing the Modernisation Fund with an additional 2.5% of the cap to further support the energy transition in lower-income Member States. The additional 2.5% cap should be calculated on the entire 2021-2030 period (just like the increased LRF).
- **Lower the Market Stability Reserve (MSR) thresholds.** The introduction of a buffer zone between the total number of allowances in circulation (TNAC) and the MSR's upper threshold (833 million) is welcome, but its upper level of 1,096 million would weaken the effectiveness of the MSR (*ceteris paribus*). To address this, both the MSR's buffer zone upper level (1,096 million) and the upper threshold for hedging (833 million) should be lowered to properly reflect an increasingly decarbonised economy and gradually declining hedging requirements. The exact levels should be determined through analysis to ensure a smooth market functioning.
- **Reform the EU ETS product benchmarks as soon as possible.** We welcome the Commission's intention to revise the scope of the benchmarks for hydrogen and heat to avoid installations with decarbonised processes falling out of the ETS and to remove references to specific feedstocks and production processes. In the case of district heating and cooling, the revision should reflect different starting points and prevent a disproportionate increase of heating prices. The benchmark reform will speed up the adoption of newer, cleaner technologies. Such reform should happen as soon as possible and not wait until the start of the second half of Phase IV.
- **Make the Modernisation Fund future-proof.** Gas-based projects could be financed, provided that i) they are carried out as part of a credible decarbonisation plan in accordance with the 2030 climate target and the EU's 2050 net-zero GHG emission target, ii) they are able to be upgraded for new decarbonisation technologies in the future and iii) electrification is not technologically nor commercially feasible at reasonable cost.
- **Support the development of a European carbon market.** The introduction of a Carbon Border Adjustment Mechanism (CBAM) for electricity is welcome, but ultimately its end goal should be to encourage neighbouring markets to develop their own carbon markets and link them to the EU ETS. Building on the successful link with the Swiss ETS, further linkages would support a larger, more stable carbon market and enable a level playing field with electricity generated at the other end of interconnectors.

Accelerating market-led decarbonisation through the EU ETS reform

The Fit-for-55 package must enable Europe to reduce greenhouse gas emissions by at least 55% by 2030 and put the EU on the right pathway towards achieving its climate-neutrality goal by 2050. The EU Emissions Trading System (EU ETS) should continue to be a core instrument to reach the increased climate ambition in the sectors that it covers. We therefore welcome the Commission's proposal to reform the EU ETS. In particular, and in line with Eurelectric's [May 2021 EU ETS reform position paper](#), we support the following proposals:

- **Increased linear reduction factor (LRF) to 4.2%** in combination with a **one-off reduction** of 117 million allowances by 1 January 2024. It is only logical that the LRF is revised in line with the revised 2030 climate target, suggesting a significantly higher LRF is needed than today. Early action before the mid-20s is key for investor predictability and cost efficiency purposes: The earlier the LRF is adjusted, the less steep it has to be to reach the same point in 2030. Eurelectric therefore also supports the proposed one-off reduction of the cap, which allows for a smoother trajectory overall and reflects the fact that the nominal cap is considerably higher than actual emissions. It will guarantee the regulatory predictability and transparency needed to achieve a strong carbon price signal. The introduction of a one-off reduction of the cap would also alleviate some of the pressure on the MSR. The impact of the proposed changes should in any case be assessed to ensure a predictable price trajectory until 2030, keeping in mind the risk of volatility in the ETS market and the distributional effects this entails.
- **Maintained Market Stability Reserve (MSR) intake rate of 24%.** This is crucial in order to keep a strong potential for tackling new EU ETS market imbalances that might occur in the future.
- **Increased Modernisation Fund.** To address the distributional and social effects of the transition, we welcome the proposal for auctioning an additional 2.5 % of the cap to financially support the energy transition of the Member States with GDP per capita below 65 % of the EU average in 2016–2018, through the Modernisation Fund. Eurelectric does believe that the additional 2.5% should be calculated for the entire period of 2021–2030 (just like the increased LRF) instead of 2024–2030.
- **Increased Innovation Fund and introduction of Carbon Contracts for Difference in its scope.** Both are highly needed for reaching the new 2030 climate targets for industries and the power sector. For both to be successful, Eurelectric proposes specific competitive tendering mechanisms for breakthrough technologies that are currently not yet cost competitive (e.g. renewable hydrogen projects), provided that they are compatible with the EU ETS.
- **Use of national carbon revenues.** We welcome the proposal to direct all auctioning revenues to climate-related activities to empower member states to finance the energy transition. Because auction revenues should be available for financing the energy transition, priority should be given to this instead of the integral EU budget as own resources.
- **Creation of stand-alone ETS for road transport and buildings.** Eurelectric agrees that other sectors should be subject to carbon pricing with a dedicated GHG reduction target in order to share the weight of the increased 2030 climate target in a cost-efficient way. This should not lead to an automatic merging with the existing EU ETS, until the stand-alone ETS has proven to work well, and it does not negatively impact the integrity and functioning of the existing ETS. Furthermore, we call for policy coherence between different instruments in the fit-for-55 package to ensure a straightforward implementation whilst the “polluter pays” principle remains respected. This also means that double CO₂ pricing of EU ETS installations should be avoided.

In addition to these proposed revisions that we support, we encourage EU policymakers to further improve market-led decarbonisation and stability by considering the following changes to the Commission proposal:

Lower the Market Stability Reserve (MSR) thresholds

The European Commission proposes to keep the MSR's intake rate at 24% as long as the total number of allowances in circulation (TNAC) is above 1,096 million allowances but lower this when the TNAC is between 833 and 1,096 million (the buffer zone). In the buffer zone, the intake rate will be the difference between the TNAC and 833 million (the MSR's upper threshold)

Eurelectric believes that this buffer zone will actually weaken the effectiveness of the MSR (*ceteris paribus*) and therefore proposes to lower both the MSR buffer zone's upper level (1,096 million) and the upper threshold for hedging (833 million). The European Commission suggests it is maintaining the existing upper threshold for hedging at 833 million as lowering it would lead to market uncertainty. Eurelectric does not share this assessment and actually thinks that lowering it would improve the effectiveness of the MSR. Furthermore, decreasing the upper threshold for hedging is necessary because it would properly reflect an increasingly decarbonised economy and gradually declining hedging requirements in the power, industrial and aviation sectors. The level to which the MSR buffer and the upper hedging threshold should be reduced to should be determined by robust analysis.

Reform the EU ETS product benchmarks as soon as possible

The current scope of the EU ETS product benchmarks (covered in [Commission Delegated Regulation 2019/331](#) and [Commission Implementing Regulation 2021/447](#)) is centred around very specifically-defined technologies or production processes. This is an issue for many sectors because it disfavors innovation in breakthrough technologies. In this paper, Eurelectric would like to zoom in on the issues observed in the power sector.

For **hydrogen**, the product benchmark refers to steam reforming of hydrocarbon feedstock, but the production of hydrogen through electrolysis is not described. Once an installation for example switches to hydrogen based on electrolysis using renewable or low-carbon electricity, it would fall out of the scope of the EU ETS Directive and therefore no longer be eligible for free allowances, whereas its competitors that continue to focus on conventional emitting hydrogen processes would continue to receive free allowances. This creates a competitive distortion that disfavors the adoption of new, cleaner technologies.

Fortunately, the European Commission in section 30 of its EU ETS impact assessment acknowledges this potential barrier and as two of the options, has proposed to revise the scope of the benchmarks by i) avoiding that installations with partly or completely decarbonized processes fall out of the EU ETS or cannot enter it, and ii) align benchmarks with the principle of 'one product, one benchmark', which would remove references to specific feedstocks or production processes so that they will include low-carbon production routes. Eurelectric welcomes these proposals for making the hydrogen benchmark fit-for-purpose. The appropriateness of the production capacity thresholds for hydrogen under Annex I of the EU ETS Directive should also be assessed considering the size of current electrolyser projects.

In addition to the hydrogen benchmark:

- The ‘one product, one benchmark’ option for the **heat** benchmark could also be considered, because doing so would include heat produced from electricity. Eurelectric does however note that in the context of the district heating and cooling sector, the benchmark revision should reflect different starting points. Higher district heating prices may lead users going off-grid and deploy individual fossil-based heat sources, which would hamper the switch of large-scale district heating systems from fossil-based to low-carbon energy sources.
- Eurelectric disagrees with the European Commission’s proposal to exclude combustion installations that use more than 95% of **biomass** from the scope of the EU ETS. Excluding them will risk creating perverse incentives where combustion installations are incentivised to blend fossil fuels with their biomass just to stay in the EU ETS.

Time is of the essence, and therefore Eurelectric urges the European Commission to propose the necessary changes to the relevant Delegated and Implementing Regulations as soon as possible, and not wait until the next allocation period starts in the second half of Phase IV (1 January 2026). It could provide a significant boost to the uptake of breakthrough technologies as a substitute for conventional production technologies in general.

Make the Modernisation Fund future-proof

Eurelectric believes that gas-based projects could be financed under the Modernisation Fund, provided that:

- They are carried out as part of a credible decarbonization plan in accordance with the new 2030 climate targets as well as the EU’s net-zero GHG emission target of 2050.
- They are able to be upgraded for new decarbonization technologies (e.g. hydrogen) in the future.
- Electrification is technically or commercially not available at a reasonable cost.

Support the development of a European carbon market

The introduction of a Carbon Border Adjustment Mechanism (CBAM) for electricity is welcome, but ultimately its end goal should be to encourage neighbouring markets to develop their own carbon markets, and link them to the EU ETS. Building on the successful link with the Swiss ETS, further linkages would support a larger, more stable carbon market and enable a level-playing field with electricity generated at the other end of interconnectors.

Eurelectric pursues in all its activities the application of the following sustainable development values:

Economic Development

- Growth, added-value, efficiency

Environmental Leadership

- Commitment, innovation, pro-activeness

Social Responsibility

- Transparency, ethics, accountability



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