

FIT FOR 55 - EU ALIGNS EMISSIONS TRADING SYSTEM WITH 2030 CLIMATE AMBITIONS

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Legal Briefings

We size up EU plans to overhaul its emissions trading system as part of ambitious plans to slash pollution by 2030

The EU Commission has published a [proposed Directive](#) to amend the EU Emissions Trading System (ETS) Directive ([Directive 2003/87/EC](#)), the Market Stability Reserve (**MSR**) Decision ([Decision \(EU\) 2015/1814](#)) and the MRV Regulation ([Regulation 2015/757](#)). Being part of the EU's "Fit for 55 Package", the purpose of these amendments is to align the EU ETS Directive with the EU'S 2030 ambition to reach the legally binding 55% net emissions reductions target by 2030 under the EU Climate Law. Below, we have summarised the key amendments of these proposals.

The key changes are:

- an expansion of the EU ETS to cover maritime transport;
- an increase of the linear reduction factor to 4.2% (from previous 2.2%);
- introduction of emissions trading for buildings and road transport; and
- confirmation that the normal intake rate for the MSR at 24% will apply until 2030.

EU ETS DIRECTIVE AMENDMENTS

Maritime Transport

From 2018, pursuant to the MRV Regulation, large ships over 5,000 gross tonnage loading or unloading cargo or passengers at ports in the EEA must monitor and report their CO₂. The Commission now proposes to extend the EU ETS Directive to cover emissions from these ships from intra-EU voyages, half of the emissions from extra-EU voyages and all emissions occurring at berth in an EU port. The same rules on auctioning, transfer, surrender and cancellation of allowances, penalties and registries that apply to other sectors under the EU ETS will apply. Under the Directive, shipping companies will have to surrender 100% of their verified emissions as of 2026, an obligation which will be phased in between 2023 and 2025 as follows:

Year	Surrender Allowances (% verified emissions reported that year)
2023	20%
2024	45%
2025	70%
2026 onwards	100%

During this phase-in period between 2023 and 2025, to the extent that fewer allowances are surrendered, the allowances not surrendered should be cancelled rather than auctioned. The monitoring and reporting rules as well as verification and accreditation rules from the MRV Regulation, as amended, shall apply.

In addition to the general EU ETS rules on penalties, the Directive proposes to introduce expulsion orders, which may prevent entry into an EU port and the ship being detained by the flag Member State. These can be issued against ships if there has been a failure to surrender allowances for two or more consecutive reporting periods.

The Commission has also proposed to present a report to the European Parliament and the Council by 30 September 2028 in relation to the proposed global market-based measure for maritime emissions proposed by the International Maritime Organisation.

Linear Reduction Factor and one-off cap reduction

The linear reduction factor will be increased to 4.2% (from previous 2.2%) from the year following the entry into force of the Directive. The increased linear reduction factor is combined with a one-off downward adjustment of the cap so the new linear reduction factor will be in line with this level of reduction having been applicable for 2021. From this same year, the cap will be increased to reflect the maritime transport emissions to be included in the EU ETS and derived from data from the EU maritime transport monitoring, reporting and verification (**MRV**) system for the years 2018 and 2019, adjusted from year 2021, by the linear reduction factor.

Use of auction revenues

Currently, 2% of allowances are used to support the Modernisation Fund for Member States with a GDP per capita at market prices below 60% of the EU average in 2013 (**Beneficiary Member States**). The Commission now proposes that an additional 2.5% of allowances will be used to fund the energy transition of Member States with a GDP per capita below 65% of the EU average in 2016-2018.

Furthermore, to the extent that they are not attributed to the Union budget, all proceedings from auction revenues must be used for climate-related purposes. Adjustments to the EU budgetary framework will be included as part of the upcoming "Own Resources" package including a proposal to amend the multiannual financial framework, a more stringent benchmark approach and establishing conditionality for free allocation.

The free allocation mechanism is based on a product benchmark that is calculated based on the average GHG emissions of the best performing 10% of the installations producing that product in the EU and EEA-EFTA states. Installations that meet the benchmark will receive all allowances required to meet their emissions, but those that do not meet the benchmark will receive fewer allowances. Previously under Phase 4, the benchmarks were to be reduced by an annual minimum rate of 0.2% up to a maximum rate of 1.6%, leading to reductions of the benchmarks between 3% and 24% over the 15 years between 2008 and 2023, the mid-point of the period 2021-2025. Under the new Directive, the maximum annual adjustment will be increased from 1.6% to 2.5% per year as of 2026. The determined Union-wide benchmarks shall be reviewed before 2026.

Furthermore, in order to incentivise the use of low-carbon technologies, free allocation will be made conditional on decarbonisation efforts. Installations which are required to conduct an energy audit under the current Article 8(4) of the Energy Efficiency Directive ([Directive 2012/27/EU](#)) (**EED**) will be required to implement the recommendations, or demonstrate the implementation of measures with emissions reductions equivalent to those made in their respective installations audit report. If they do not comply, their free allocation shall be reduced by 25%. Currently, SMEs are exempted from carrying out an energy audit. It is proposed that this should be changed under the revised EED so that the exemption is instead based on energy consumption.

It was further clarified that sectors which will be covered by a Carbon Border Adjustment Mechanism (**CBAM**) should not receive free allocation under the EU ETS. There will be a transitional period put in place to adjust to the new regime, with a gradual reduction of free allocation as the CBAM is phased in, to reach no free allocations by the tenth year of the operation of the CBAM.

Carbon Contracts for Difference (CCDs)

The Innovation Fund is intended to be geared towards innovative technologies that would not be commercially viable at scale without support but must be sufficiently mature for application at pre-commercial scale. Support under the Innovation Fund for these projects has been extended to allow it to provide support in the form of price competitive tendering support such as CCDs. In this case, up to 100% of the relevant costs of projects may be supported.

Furthermore, the Innovation Fund is increased by 50 million allowances sourced from auctioning (10 million) and the allowances available for free allocation (40 million).

Modernisation Fund

The Modernisation Fund is a fund to support investments proposed by the beneficiary Member States including the financing of small-scale investment projects to modernise energy systems and improve energy efficiency. The investments made into the Modernisation Fund must be consistent with the objectives of the European Green Deal, the European Climate Law and Paris Agreement. The proposal states that support will no longer be provided to energy generation facilities that use fossil fuels of any kind, as opposed to only solid fossil fuels as is currently the case. In addition, the percentage of the fund that must be invested in priority investments has been increased from 70% to 80%. Examples of priority investments include: the generation and use of electricity from renewables, the support of households to address energy poverty concerns and a just transition in carbon-dependent regions of the beneficiary Member States.

CCUS

Under the proposal, surrender obligations will not arise for emissions of CO₂ that have been captured and utilised to be permanently chemically bound in a product so that they do not enter the atmosphere under normal use.

Removal of barriers for innovative low-carbon technologies by modifying the EU ETS scope and benchmarks

Previously, innovative technologies that fell outside of the EU ETS were at a competitive disadvantage. These technologies may fall out of the EU ETS because they change their production process or their total rated thermal input of the combustion units of an installation decreases to less than 20MW. In contrast, efficient technologies just below benchmark level receive more free allocation than they emit.

The proposal attempts to rectify this by making the following changes:

Installations will stay within the EU ETS where they reduce the total capacity of their combustions units to reduce emissions;

- Making the definitions of activities technology neutral;
- Referring to production capacities instead of combustion capacities; and
- Reviewing the benchmark definitions to ensure equal treatment of installations independently of the technology used, including when using low or zero-carbon technologies.

Introduction of emissions trading for buildings and road transport

The proposal establishes a new system for emissions trading for buildings and road transport as a separate self-standing system from 2025. This new system will apply to emissions in relation to release for consumption of fuels which are used for combustion in the buildings and road transport sectors. However, it shall not include: (i) the release for consumption of fuels that are otherwise covered by this Directive (for example; the refining of mineral oil, production of ammonia, and production of coke) unless used for combustion in the activities of transport of GHGs for geological storage; or (ii) the release for consumption of fuels for which the emissions factor is zero.

The scope of the sectors of buildings and road transport is defined on the basis of relevant sources of emissions included in the [2006 IPCC Guidelines for National Greenhouse Gas Inventories](#). The regulated entities are defined in line with the system of excise duty of Council Directive (EU) [2020/262](#). The emissions cap will be set from 2026 based on data collected under the Effort Sharing Regulation and emissions targets for the sectors of buildings and road transport (to reach 43% 2005 emissions by 2030).

Under this new system, the MRV obligations will be largely aligned with those established for stationary installations and aviation. In the first year, regulated entities are required to hold a greenhouse gas emissions permit and to report their emissions for 2024 and 2025, with allowances and compliance obligations applying from 2026. The total quantity of allowances for 2028 will be adjusted on the basis of the available MRV data for the period 2024-2026. The linear reduction factor will only be revised if the MRV data is significantly higher than the initial cap. A MSR will be in operation from the start. From 2026, Allowances for the new emissions trading will be auctioned unless placed in the MSR and a certain amount of allowances will be front-loaded.

The proposal has also stated that emissions trading for road transport and buildings will contribute to the already existing low-carbon funds. 150 million allowances will be made available to the Innovation Fund to stimulate the green transition.

The Commission will propose a review of the rules by 1 January 2028 if necessary.

MSR DECISION AMENDMENTS

The MSR is managed in accordance with [Decision \(EU\) 2015/1814](#). As part of the Fit for 55 Package, the Commission has proposed a [new Decision](#) to amend Decision (EU) 2015/1814, and has made a number of further proposed amendments to the MSR regime within the proposal for the updated EU ETS Directive. The key changes to the MSR are summarised below.

Taking into account net demand from aviation and maritime

The calculations for the total number of allowances in circulation (**TNAC**) and the reserve are proposed to be amended to include the previously excluded aviation emissions and allowances issued in respect of aviation if they have occurred, or were issued as of the year following the entry into force of the amendment.

In addition to aviation allowances, maritime allowances will also be included in the calculation of the reserve through modifications to the text to include allowances and emissions in relation to the maritime sector. The difference between verified emissions and allowances surrendered for the maritime sector, which will be cancelled rather than auctioned will be counted towards the TNAC as if the allowances had been issued.

Intake Rate

The intake rate mechanism is amended under the proposal to include a buffer MSR intake when the TNAC is between 833 million and 1096 million. In this case, the intake into the reserve is the difference between the TNAC and the 833 million threshold. This intake will be placed into the reserve for 12 months from 1 September that year. However, where the TNAC is above 1096 allowances, the normal intake rate will apply (24% until 2030).

In conjunction with a [further proposal](#) amending the MSR decision, the 24% intake rate and the minimum amount to be placed in the reserve of 200 million allowances, which were due to expire in 2023, are now proposed to continue until 2030.

The TNAC calculation has been amended so that only allowances issued and not put in reserve are included in the supply of allowances. In addition, the number of allowances in the reserve is no longer subtracted from the supply of allowances. The Commission has noted that these changes should have no material impact on the result of the calculation.

Invalidation mechanism

From 2023, allowances in the MSR above the level of auction volumes of the previous year will not be valid. As the level of auction volumes of the previous year is dependent on the cap and the operation of the MSR, to ensure the level of allowances in the reserve is more predictable, it is proposed that the number of allowances in the reserve is limited to 400 million allowances.

MSR for the emissions trading for road transport and buildings

An MSR will operate for emissions trading of road transport and buildings, with a number of allowances for these new sectors created in the reserve. The intakes and releases of allowances will be based on the thresholds for the surplus of allowances in that market.

Measures are established to allow for release of additional allowances from the MSR, with the triggering mechanism for the release based on the increase in the average allowance price as opposed to the surplus of allowances in the market.

AMENDMENTS TO THE EFFORT SHARING REGULATION

The Effort Sharing Regulation (Regulation 2018/842) (**ESR**) establishes an annual emissions budget for each member state that declines at a linear rate towards its individual nationally binding ESR target for 2030. This mostly concerns sectors that are not included in the EU ETS. As part of the Fit for 55 Package, a separate [proposal](#) has been published to amend this regulation in accordance with the revised EU targets. The envisaged changes to the ESR are summarised below..

It is proposed that the scope of the ESR be adjusted to take into account the proposed inclusion of maritime transport into the EU ETS as detailed above. Specifically, Malta will be given access to an increased ETS flexibility (from 2% to 7%) and has been provided with a deadline to indicate whether it intends to use this.

Furthermore, it is proposed that the framework under which the Commission will set the new Member States' annual emission levels in the years 2023-2030 will be updated. This will include updating the national annual emission allocations and making use of the new data that will become available in accordance with the 2025 review to allow an adjustment of the annual emission allocations for 2026-2030.

It is proposed that use of the Land Use, Land-Use Change and Forestry (**LULUCF**) flexibility will be split into two five-year periods and each period will be subject to a cap corresponding to half the total amount. If a Member State exceeds its removals in the 2021-2025 period, the amount exceeded will be deducted from the Member State's annual emission allocations.

Any unused LULUCF credits at the end of the second compliance period may be used to set up a voluntary additional reserve. This reserve is to be used by Member States in order to comply with their ESR 2030 target, subject to the condition that the 55% reduction EU-level target is reached with a maximum contribution of 225 MtCO₂Eq of net removals in accordance with the European Climate Law.

MORE ON THE FIT FOR 55 SUITE OF PROPOSALS

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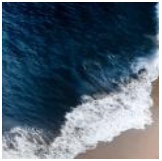
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