BACKGROUND NOTE

Provisional Agreement EU ETS Directive and Social Climate Fund Regulation

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Background

The proposal for a revision of the **EU ETS Directive** was presented by the Commission on 14 July 2021 as part of the Fitfor55 package to deliver on the increased level of ambition towards at least 55% net emission reduction for 2030 set out in the European Climate Law. The sectors currently covered by the EU ETS account for around 41% of the EU's total emissions and has been the most successful instrument in reducing emissions. The revision of the EU ETS is therefore crucial to achieving the overall target. The Commission proposed that emissions from the current EU ETS sectors (stationary industry) be reduced by 61% by 2030 compared to the current 43%. In addition, the Commission proposed to apply emissions trading in new sectors where sharper reductions are needed to reach the 2030 target. Under the proposal, emissions from maritime transport will be included in the existing EU ETS, while emissions from fuels used in road transport and building heating will be covered by a new, separate emissions trading system.

The proposal for a **Social Climate Fund** Regulation was presented by the Commission on 14 July 2021 as part of the Fitfor55 package to deliver on the increased level of ambition towards at least 55% net emission reduction for 2030 set out in the European Climate Law, in particular to address the social and distributional impact on the most vulnerable arising from the proposed emissions trading for the sectors of building heating and road transport.

A provisional agreement was reached on 18 December at 2AM after more than 30 hours of negotiations.

The provisional agreement improves the overall outcome on key points in the direction of the EPP line.

Content of the provisional agreement

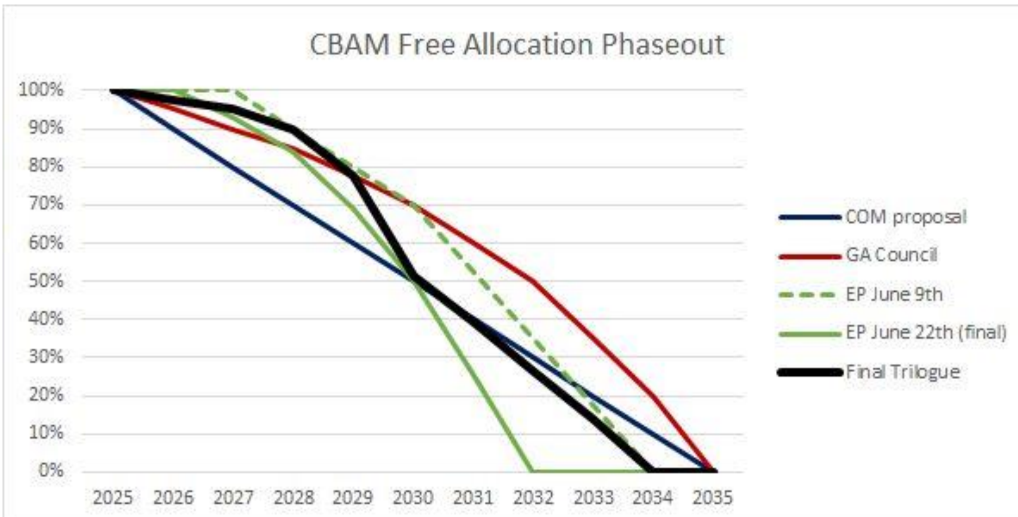
1. ETS 1 stationary installations:

a. Overall ambition: Parliament agreed on a compromise to reduce emissions from the current EU ETS sectors (stationary industry) by **62% by 2030** compared to 2005, improving the Commission proposal of 61%, while
   - securing the EPP priority to provide **breathing space to industry** in the short term through a split rebasing of 90 million allowances in 2024 and 27 million allowances in 2026;
   - ensuring this **ambition is reached in the medium-term** through an LRF of 4.3% (24-27) and 4.4% (28-30);

- **no changes to the Market Stability Reserve** (24% intake rate and current thresholds maintained);

b. Free allocation:

- The **indirect cost compensation** regime is maintained.
- On **CBAM**, a compromise moving closer in the direction of the EPP line was achieved, balancing **breathing space** in the short term with reaching the required ambition in the medium term through a 2026-2034 trajectory with a **slower start** (2.5%, 2.5%, 5% in the first three years) and a **later full phase-out date** for free allocation than the EP mandate, reaching a percentage of 48.5% free allocation phase out in 2030, while having **30 million free allowances less phased out by 2030 (165) than in the EP mandate (195)**.



- **Strong package on export safeguards for CBAM sectors**, consisting of 5 elements:
  - a **legal guarantee** that free allocation is not phased-out in case CBAM does not phase-in (contrary to the automatic free allocation phase-out in the Commission proposal regardless of what happens on CBAM);
  - an **new, additional amount of more than 3.5 billion euro** with which Member States can support their exporting industry;
  - in addition Member States can spend their **national ETS auction revenues to support exporting industry**;
  - **dedicated calls in the Innovation Fund** for CBAM sectors;
  - a **review and legislative proposal** on export safeguards before the end of the transition period.
- The current **steel benchmark derogation is continued**, contributing to an additional 18 million free allowances on annual basis for the steel sector.
- Parliament agreed to Council's mandate for **additional free allocation for district heating**.
- A middle-ground compromise was reached on a **minimum benchmark update rate of 0.3%;**
- **Incentives for decarbonisation:**

- Council agreed on **two reward mechanisms** for installations proposed by the Parliament:
  - possibility for installations who decarbonise to stay longer in the EU ETS and thus benefit longer from free allowances to reward their investments;
  - exempting the 10% best performers from the cross-sectoral correction factor.
- a **20% conditionality** was agreed to incentivise decarbonisation, whereby:
  - the 20% worst-performing installations in a benchmark need to meet 2 conditions (energy audit/management schemes and decarbonisation plans)
  - all other installations only need to meet the energy audit/management scheme conditionality

c. Market functioning:

- **Strengthened Article 29a** against excessive price increases through a lower threshold to trigger the mechanism combined with an automatic release of allowances from the MSR when triggered, in line with the Council's mandate.
- **Strengthened disclosure requirements** for market actors and strengthened, regular monitoring and reporting requirements against manipulation in the ETS market.

d. Scope:

- CCU/CCS/negative emissions: **CCS and permanently bound CCU are fully exempted** from surrender requirements in the EU ETS, while there is a review clause on the **possible inclusion of negative emissions** and on the accounting of non-permanently bound of CCU in light of **incentivizing CCU** in 2026.
- Waste: **municipal waste incineration** will be covered by a monitoring, reporting and verification scheme from 2024, followed by an impact assessment and legislative proposal by the Commission in 2026 with the aim to include the sector in the EU ETS from 2028 while providing opt-outs until the end of 2030.
- **Biomass**: Parliament agreed to the Council mandate to lower the threshold to 95%.

e. Financial mechanisms:

- **Innovation Fund is substantially increased**
  - from 450 million allowances currently to at least 575 million allowances, which in combination with a higher carbon price of 75 euro leads to a Fund of more than 43 billion euro;
  - **low-carbon** remains in the scope and **carbon contracts for difference** and **upscaling** become part of the scope, while **geographical balance** should be ensured in the calls.
- **Modernisation Fund:**
  - the Fund is increased with a 2.5% top-up, which will be oriented towards clean projects (90% priority share)
  - some support for **gas-related projects** is maintained and reintroduced for gas-fired power plants compared to the Commission proposal, but **under strict conditions**;

    - the **priority share** is set at 80% for the 'old' MF share and 90% for the new top-up;
    - in relation to this, free allocation for gas power plants **(article 10c) will be ended**, but those (3) Member States who still have some article 10c allowances can use them instead in the Modernisation Fund or for auctioning;
    - the Parliament's national climate neutrality requirement is dropped.
- **Use of national revenue: 100%** of national EU ETS revenue **shall be spent on climate-related activities**, a significant win for the Parliament, and reporting requirements are strengthened.

2. ETS maritime

a. Phase-in: a balanced compromise was reached to **phase-in** the sector starting with surrendering of allowances for
- 40 % of emissions of 2024
- 70 % of emissions of 2025
- 100 % of emissions of 2026

b. Scope: a balanced compromise was reached whereby
- Parliament agreed to the **Council's mandate on geographical scope** (100% intra-EU and in port, and 50% extra-EU voyages) in combination with a strong IMO review clause;
- greenhouse gases covered are expanded from CO_2 to also include **CH_4 and N20** in the EU ETS from 2026
- vessels:
    - Parliament agreed to the Council's mandate on **vessels above 5000Gt at the start** of the EU ETS;
    - **large offshore service vessels** above 5000Gt are also included in the MRV from 2025 and in the EU ETS from 2027;
    - small general cargo vessels and offshore service vessels between 400Gt and 5000Gt will be included in the MRV from 2025, with a **review clause** in 2026 on their potential inclusion in the EU ETS; in addition, there will be a review clause on the potential inclusion of other small vessels in the MRV at the end of 2024.

c. Use of revenue:
- **20 million allowances** from the maritime auctioning are added to the **Innovation Fund for dedicated maritime calls**, with the possibility for the maritime sector to also access other calls in the Innovation Fund;
- Parliament agreed to Council's mandate to **transfer 3.5% of allowances to MT, CY and EL**;

d. Derogations: Parliament accepted the Council's mandate on derogations for
- **outermost** regions
- **small island** connections within a Member State
- certain public service connections between 2 Member States (Greece-Cyprus)

- **ice-class** ships

e. Other points: Council agreed to a compromise on the two key safeguards in the Parliament's mandate:
   - **anti-evasion safeguards** to counteract circumvention to non-EU transhipment ports within 300 nautical miles of EU ports;
   - provisions on **mandatory transfer of costs** to commercial operators.

3. ETS 2 building heating and road transport

A new EU ETS for fuels for building heating and road transport will be established, subject to strong social safeguard mechanisms and in combination with a Social Climate Fund.

a. Start date:
   - **Social Climate Fund is frontloaded and starts in 2026**, one year before the start of the new ETS 2;
   - start of the new **ETS 2 is delayed by one year to 2027**, to ensure the Fund can start one year before the start of the new ETS 2
   - possibility to apply a **one-off emergency brake** for the **ETS 2 to start in 2028** if gas or oil prices are too high;

b. Safeguards
   - a **price cap/stabilisation mechanism** ensures that the price is stabilized at a maximum of **45 euro;**
   - in addition, an **excessive price mechanism** ensures the price cannot rise too sharply at any given time also below 45 euro.
   - the **cost-pass through** from fuel suppliers to final consumers will be reported and monitored by the Commission, and in the case the Commission finds that malpractices exist with regard to the pass through of carbon costs, the Commission is required to present legislative proposals to address this;

c. Scope:
   - the scope of the ETS 2 is extended to **cover certain other fuels** for process heating not yet covered, and 20% of these revenues will be used to increase the size of the Social Climate Fund;
   - there is a national opt-out, subject to strict requirements, intended for Ireland;

4. Social Climate Fund

a. Size, start date and budgetary architecture:
   - SCF will **start 1 year before** the new ETS 2

- SCF will be **substantially increased** compared to the Council and Parliament proposals, to **86,7 billion euro**, which includes **25% national co-financing**;
- a compromise was agreed to **start the financing of the Fund through external assigned revenue** sourced from ETS 2 auction revenues, with a strong clause in an **article to include the Fund under the next Multiannual Financial Framework**;
- No change to the **allocation key proposed by the Commission** based on share of population at risk of poverty living in rural areas (proxy for vulnerable transport users), household emissions and arrears in utility bill (proxy for energy poverty and consumption vulnerability), adjusted for GNI per capita, with the exception of the setting of a **minimum amount of 0.07% per Member State**, benefitting Malta.

b. Eligible beneficiaries: the Fund will target **vulnerable households and transport users - including the lower middle income ones** - and micro-enterprises in energy poverty or transport poverty. Parliament achieved a new EU-level definition of transport poverty.

c. Eligible measures and investments:
- a compromise was agreed that up to **37.5%** of the Fund can be used for **direct income support**, connected to also providing structural measures and investments to help those targeted beneficiaries in the medium- and long-term;
- the main focus is on **targeted, structural measures and investments** targeting building renovation and zero- and low-emission transport;
- all measures and investments shall contribute to **reduce fossil fuel dependency**, in order to also structurally help the most vulnerable households avoid the ETS 2 cost in the longer term, and the do no significant harm principle applies to all measures and investments.