

# - EEX public consultation response - Updating the EU Emissions Trading System

**The European Energy Exchange (EEX) strongly supports the European Commission's objective of strengthening the EU Emissions Trading System (ETS) as pursued in this review exercise.** Both in light of Europe's 2050 carbon neutrality target and increase of the 2030 ambitions to 55% GHG emissions reductions as well as the need for a sustainable recovery. The drop in CO<sub>2</sub> emissions throughout 2020 as consequence of the Covid-19 crisis occurred at a huge human and economic cost. This will have been futile and temporary unless structural efforts are made for the long term to avoid a rapid rebound.

**The EU ETS is the European Union's central climate policy instrument and ensures emissions reductions in the most cost-efficient manner in the sectors it covers.** This stands in contrast to emissions reductions in non-ETS sectors, where results are mixed and decarbonisation potential remains untapped. Therefore, there needs to be a holistic framework at EU level that incentivises carbon abatement in a market based and most efficient manner. Against this background, emissions trading as a policy instrument will have a key role to play in achieving the climate targets, with focus on using the full potential of the joint EU ETS. To this end, we make the following five policy design considerations:

**First, to strengthen the carbon price signal and EU ETS, it's most important to align the emissions cap with the increased target for 2030.** This is foremost achieved by a clear long-term framework for the Linear Reduction Factor (LRF) and its timely implementation which contributes to the system's predictability and functioning of the market in the most efficient way.

**Second, integrating additional sectors into emissions trading at EU level presents important benefits in terms of effectiveness and harmonisation.** In the long term, the heating and transport sectors should be integrated into the EU ETS. To take account of diverging abatement costs and to preserve the integrity and efficiency the common system has reached, establishing a parallel system could be a reasonable interim solution in the short- to medium term.

**Third, increased climate ambition should be combined with an increased share of auctioned allowances.** This is fundamental to the objective of emissions trading as it guarantees costs of carbon are internalised. It will also spur innovation and decarbonisation in the industrial sectors for which its inclusion in the EU ETS has not yielded substantial reductions in emissions.

**Fourth, certain other policies and support mechanisms for low-carbon technologies may support abatement in sectors with the largest untapped decarbonisation potential.** Allocation of the Modernisation and Innovation Funds should occur in a consistent manner with the climate ambition and the EU ETS's markets.

**Fifth, global cooperation in carbon pricing and carbon diplomacy needs to be intensified to preserve European competitiveness and increase the international role of the Euro.** The EU ETS is still the largest and most important cap and trade system in the world. Any regulatory adjustments are likely to be widely noted and hence significantly influence global emissions trading.

**Finally, underpinning all the above considerations is the nature of the EU ETS as a volume-based cap and trade system with free price formation. It is of fundamental importance to the system's continued success to persist with this approach.**

## EEX supports the European Green Deal

The European Energy Exchange (EEX) welcomes Europe's 2050 carbon neutrality target and increase of the 2030 ambitions to 55% as a pivotal step to assert its role as global climate action leader. Achieving this level of ambition will be key not only to the EU's own climate policy efforts, but also to global cooperation with partners to reduce emissions and ultimately deliver on the goals of the Paris Agreement on climate change. Emissions and energy markets will be a key instrument in delivering on Europe's long-term climate ambitions.

EEX is involved in the EU ETS through its appointment as the Common Auction Platform with over 2000 successful auctions as well as Opt-out Platform for Germany and conducting auctions in Poland, and as a secondary trading platform for emission allowances since the very inception of the EU ETS in 2005.

Beyond Europe, EEX is a strong advocate and active supporter of increased cooperation and mutual learning as a key policy tool to achieve global emissions reduction targets. EEX Group actively supports emission markets developments in New Zealand and China in collaboration with local partners as well as in North America with Nodal Exchange.

Building on this experience, we believe the joint scheme is key in achieving climate neutrality at the lowest possible cost, with focus on using its full potential. Therefore, we strongly support the European Commission's objective of strengthening the EU ETS as pursued in this review exercise. With this paper, we offer additional clarifications and nuance to our response to the questionnaire on Updating the EU Emissions Trading System.

## A strong carbon price signal and EU ETS as foundation for climate neutrality

**The EU ETS is the EU's central climate policy instrument. It has delivered on the targets and guaranteed an emissions reduction by about 35% between 2005 and 2019.** And while currently the EU ETS covers about 40% of EU GHG emissions, this share is expected to decrease to 35% by 2030. This stands in stark contrast to emissions reductions in non-ETS sectors, where results are mixed and decarbonisation potential remains untapped. Despite widely diverging targets from a 20% decrease to a 20% increase in emissions, several member states did not meet their 2020 emissions reduction obligations in non-ETS sectors. While trading of annual emission allocations (AEA) between member states can to some extent balance this afterwards, it is only a less efficient second-best option with limited transparency and costs which are difficult to predict.

**There needs to be a holistic framework at EU level that incentivises carbon abatement in a market based and most efficient manner across economic sectors.** Against this background, emissions trading as a policy instrument will have a key role to play in achieving the EU's increased 2030 greenhouse gas reduction target, with focus on using the full potential of the joint EU ETS.

Commodity markets have proven to react well to the COVID-19 pandemic. Markets allowed businesses big and small to quickly adapt their strategies and operations to the rising volatility and fall in demand. **The drop in CO2 emissions throughout 2020 however occurred at a huge human and economic cost. This will have been futile and temporary unless structural efforts are made for the long term to avoid a rapid rebound.**<sup>1</sup> In addition, households are increasingly willing to pay the true cost of carbon if revenues thereof are used in a fair manner.<sup>2</sup> Both factors make that the time is right to enhance the role of the carbon price and emissions trading.

This should be done notably by increasing the auction share, extending the EU ETS to other sectors and spurring international cooperation. An efficient and undistorted carbon market can put transition at the center of economic recovery and capital flows. **We make the following five policy design considerations:**

<sup>1</sup> EU Climate Action Progress Report, European Commission, 2020 [link]

<sup>2</sup> Supporting Carbon Taxes: The Role of Fairness, RWI & PIK & University of Oxford, 2020 [link]

## 1. Strengthening the EU ETS ambition via a long-term cap-and-trade pathway

**The EU ETS has retained its nature as a volume-based cap and trade system with free price formation.** For the current EU ETS reform, it is of fundamental importance to the system's continued success to persist with this volume-based approach. This approach is the basis for the liquidity of the market, diversity and number of market participants in the system. **Hence, to strengthen the carbon price signal and EU ETS, it's most important to align the emissions cap with the increased target for 2030.** Market participants can then use the available short- and long-term trading products to efficiently manage their exposure to the carbon price signal, in parallel to other commodities.

**First and foremost, this is achieved by a clear long-term framework for the Linear Reduction Factor (LRF) which contributes to the system's predictability and functioning of the market in the most efficient way.** The longer the LRF is left unmodified, the more rapid decarbonisation is required in the remaining time until 2030. This could potentially affect the efficiency of the carbon market, e.g. by price movements. Therefore, a timely implementation ensures a smooth adaption of the EU ETS without potential market or price impacts due to a sudden rebasing.

**The Market Stability Reserve (MSR), based on volume triggers, provides an additional policy to manage market volumes and stability.** The mechanism has proven successful and notably addressed the surplus of allowances since January 2019 and the legislative changes agreed in recent years continue to show positive results.<sup>3</sup> In order to preserve the efficient functioning of the MSR, changes will likely have to be made to align its parameters to the current economic situation and the revised 2030 emissions reduction targets.

These changes must recognize that the MSR functions as a tool to manage supply/demand issues caused by external economic circumstances, whereas it is the LRF's role to set a clear and stable long-term framework for the trading system. Therefore, adjustments to the MSR's parameters should not be decided on before changes to other ETS policies such as market expansion, LRF, and free allocation are finalized. This will ensure that the parameters are fit for purpose, based on objective quantitative analysis and fully adapted to the revised EU ETS structure.

## 2. Sectoral expansion offers significant potential for effective decarbonisation

**Today, emissions trading already provides a cross-sector price signal which can be expanded to further sectors. The EU ETS has been expanded several times both at national and at European level.** Examples of this are the inclusion of air transport and of the aluminium sector at a European level and the national expansion with additional plants from the heating sector in several member states. Member States are already moving at different speeds with for example the German National Emissions Trading System (NETS) covering fossil fuels in the transport and heating sector entering into force in 2021. **A European common approach to sectoral expansion can build on and learn from these national experiences and will assure a level-playing field and most efficient carbon abatement across the block.**

**Integrating additional sectors into emissions trading at EU level presents important benefits in terms of effectiveness and harmonization.** It offers the possibility to introduce a cap on carbon emissions for other sectors for the first time, a real paradigm shift. This also contributes to fostering innovation in the market and increases support for carbon pricing in general.

**Against this background, EEX explicitly supports the European Commission's proposal to extend the emissions trading at European level to the additional sectors of transport and heating** or all fossil fuel use for sake of efficiency. For an increased GHG emissions reduction target of at least 55% by 2030, around 350

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<sup>3</sup> Report on the functioning of the European carbon market, COM(2020) 740 final [link]

billion EUR of additional annual investments are required compared to the past decade. Around one third of this is needed to efficiently decarbonise the transport and residential sectors.<sup>4</sup> Emissions trading in these markets will ensure an economic efficient decarbonisation and will provide market participants with a strong price signal to guide their economic activity and financial investments.

**From a market perspective, the preferred target option for implementing wider carbon pricing at European level is by including a largest possible scope of economic activities in the common EU ETS.** This would offer significant benefits as the market as a whole including all market participants directly benefit from a larger, more efficient market with increased liquidity. **Wide sectoral coverage encompassing a great number of diverse market participants optimizes the efficiency of emissions reductions.** Therefore, EEX believes the European Commission should aim to integrate these sectors into a single system, at least in the long term. Further, additional sectoral coverage can support linking of trading schemes, as the system becomes more attractive for global partners to link with.

**However, the ultimate design of including these sectors in emissions trading at European level should foremost preserve the integrity and efficiency the common system has reached. In addition, implementation and adequate pricing signals should happen relatively swift, given the urgent need for decarbonisation and investments in the transport and heating sectors. Therefore, establishing a parallel system to the current EU ETS could be a reasonable interim solution in the short- to medium term.**

A parallel system would be able to account for potentially diverging distributional effects or abatement costs and create a strong carbon price signal fit for these sectors that would otherwise not receive one through EU ETS inclusion. Adequate investments are needed fairly early in infrastructure that will take time to deploy, especially in sectors with large baseline emissions or large abatement costs – such as the heating sector. This is necessary to avoid the lock in of carbon-intensive technologies as in absence of a fitting carbon price economic actors might not make the most efficient investments required for the long-term 2050 target.<sup>5</sup>

In addition, a parallel system would allow for the set-up of an upstream regulatory approach, ensuring no interference with the current robust downstream MRV system. The German NETS regulation could serve as example. Over time, a mixed upstream and downstream regulation would serve the EU ETS.

**In the long term, EEX believes the European Commission should aim to integrate these sectors into a single EU ETS.** Therefore, policy compatibility and a clear commitment and timeframe for smooth integration should be key principles of policy design. A hard cap combined with free price formation is essential.

Once the parallel system has shown the same efficiency as the EU ETS and similar marginal abatement costs are reached, the two systems should become one. To this end, flexibilities between the parallel systems can be introduced to smoothen this transition over time. This can be approached gradually by increasing fungibility as the market matures. In analogy with international carbon credits and the EU ETS, a quantitative restriction could provide certainty that price formation happens efficiently per sectoral system<sup>6</sup> yet in time leading to inter-system price convergence and full integration into a single EU ETS. Caution should be given to preserve efficient free price formation and environmental effectiveness, avoid potential overlapping obligations and allow a transparent integration without market shocks within each of the systems.<sup>7</sup>

**To avoid double coverage of emissions, sectoral expansion must be accompanied by a transparent adjustment of effort between the EU ETS cap and ESR sectors.**

<sup>4</sup> EU Climate Action Progress Report, European Commission, 2020 [link]

<sup>5</sup> For example: Marginal abatement cost curves and the optimal timing of mitigation measures, Vogt-Schilb & Hallegatte, 2014 [link]

<sup>6</sup> Because of a link between the EU ETS and the Kyoto Flexible Mechanism, the emission certificates traded on these markets are in principle interchangeable assets; despite of this, a persistent price difference exists. Limitation of the number of offsets that could be used within the EU ETS was one factor that assured this largely separate price formation. As opposed to the initial NZ ETS where the price rapidly decreased following unlimited use of significantly cheaper priced international credits.

<sup>7</sup> For example: Transitional Restricted Linkage Between Emissions Trading Schemes, Quemin & de Perthuis, 2018 [link] - Guide to linking Emissions Trading Systems, ICAP, 2018 [link]

**In addition, given that no international climate scheme for the maritime transport sector currently exists, EEX supports placing shipping in the EU ETS.** In terms of geographical scope and mindful of potential international arrangements, the extent of EU territorial waters and/or the established SOx Emission Control Areas (MARPOL Annex VI) as well as EU territorial waters in the Mediterranean would be a reasonable width. In addition, aligning the inclusion to the existing EU MRV System in terms of exemptions and types of emissions would be the most efficient way forward.

The same counts for agricultural and LULUCF sectors and carbon removal technologies. **EEX supports the EU's "Clean Planet for All" strategy which highlights the role that negative emissions will have to play in achieving climate neutrality by 2050;** each of the eight possible scenarios in this document call for significant usage of carbon sinks. To scale up investments in support of a sustainable future, markets need a clear commitment. Long term visibility and predictability are prerequisites.

In order to ensure the stability of the ETS in the next thirty years, the European Commission will need to propose how verified carbon emission removals from all sectors that meet high quality standards can be introduced into the ETS. **Therefore, the European Commission should start sooner rather than later with anticipating a net-negative cap in order to retain an efficient and liquid market.** EEX thus welcomes the regulatory framework for the certification of CO<sub>2</sub> removals as anticipated by 2023 under the Circular Economy Action Plan and urge for a sufficiently long time horizon.

### 3. Increased climate ambition should be combined with an increased auctioning share

Increased climate ambition should be seen as opportunity to increase the share of auctioned allowances to a higher level than 57% as currently foreseen for Phase IV. Auctioning is the default allocation method for allowances in the EU ETS. It is the most transparent allocation method, providing a transparent, harmonised and non-discriminatory process. **The principle of auctioning, and the objective of gradually moving to full auctioning, is fundamental to the objective of emissions trading as it guarantees costs of carbon are internalised.** During this period, the number of industrial sectors qualifying for free allowances will already be cut as positive first step. **A linear and continuous increase of the auctioning share would provide the greatest possible predictability for market participants.**

**An increased auctioning share will also spur innovation and decarbonisation in the industrial sectors for which its inclusion in the EU ETS might not yet have yielded substantial reductions in emissions.** Emissions in these sectors fell close to 2% compared to electricity and heat production of which emissions reduced by almost 15% in 2019.<sup>8</sup>

EEX agrees on the need to address possible carbon leakage from the European Union, as well as support European businesses competing in the global market. **However, free allocation to carbon intensive production processes can have the effect of a subsidy that undermines the economic viability of low-carbon alternatives.** The pass-through of carbon costs from carbon intensive production processes is partial and uncertain and may not adequately incentivise upstream and downstream mitigation opportunities that will be necessary for climate neutrality. This is notably true for creating markets for low-carbon products, which require the carbon price to be reflected in the product price.<sup>9</sup> In addition, free allocation as a means of mitigating leakage risks will face increasing constraints, as allowance budgets decline in step with more stringent reduction targets.

**This is all the more relevant given that auctioning revenues make a significant contribution to climate finance in Europe.** In 2019, revenues from EU ETS auctioning amounted to more than 14.6 billion Euros. Member States already spent 78% of revenues for climate and energy related purposes between 2013-2019 –

<sup>8</sup> Report on the functioning of the European carbon market, COM(2020) 740 final [link]

<sup>9</sup> For example: Industrial Innovation: Pathways to deep decarbonisation of industry, ICF & DIW Berlin for DG CLIMA, 2020 [link] - Achieving Zero Emissions Under a Cap And Trade System, ICAP & Florence School of Regulation, June 2020 [link]

well above the 50% as currently required by legislation. **EEX supports the recycling of revenues if used for climate related projects or to counterbalance regressive effects.**

As explained further below, climate diplomacy and a potential Carbon Border Adjustment Mechanism (CBAM) as closely aligned with the ETS as possible serve as most efficient tools against carbon leakage.

#### **4. Market based uptake of low-carbon technologies requires a consistent use of resources and undistorted price formation**

**For an ETS to achieve emission reductions at least cost, markets must function freely and transmit uniform and non-distorted price signals to all decision makers in the economy.** The cost of carbon can be freely reflected in the price of carbon-intensive goods and guide economic operations and investment decisions.

**While unlikely to be as efficient as a long-term credible carbon price, certain support mechanisms for low-carbon technologies may support abatement in sectors with the largest untapped decarbonisation potential and remove non-economic barriers.** Such mechanisms should complement rather than substitute a strong carbon price. In this context, the EU ETS already plays a vital role as the EU's primary instrument for reducing GHG emissions cost-effectively while incentivising innovation and change via its Funds.

**Allocation of the Modernisation and Innovation Funds should occur in a consistent manner with the climate ambitions and the ETS's nature as a volume-based cap and trade system.** An increased auctioning share and a long-term cap pathway could therefore be accompanied by investment grants for high-potential low-carbon technologies. The recent success of the first Call for Proposals of the Innovation fund where over 311 applications for clean tech projects were submitted shows the success of the current financing approach. Additional sector-specific policies will also remain part of the policy mix as of now.

**We continue to strongly discourage alternatives that may interfere with the functioning of the primary and secondary carbon markets, such as a carbon price floor or carbon contracts for difference.**

First, Carbon Contracts for Difference (CCfD) are often highlighted as alternative to a strong carbon market price. The main barrier for low-carbon innovative technologies are the higher production costs as opposed to high-carbon products currently available in scale. **The most effective solution however is the strengthening of the EU ETS as laid out above, rather than implementing instruments incompatible with the ETS market e.g. CCfDs.** CCfDs ultimately risk undermining markets which are used to manage exposure to carbon price risk, by endangering its liquidity and price formation function. This may lead to short and long-term price distortions, reducing the effectiveness of the price signal as an operational and investment decisions driver.

**Relying on subsidies from governments when there are market solutions available should not be the way forward to fund the energy transition in a social and just manner.**

Second, the emissions trading price signal is the basis for efficient attainment of climate targets, with free market pricing being decisive for this. The price signal responds flexibly to external factors such as economic developments or policy changes. It is fundamental to the system's continued success to maintain this approach and strengthen the price signal in the ways proposed above. **Carbon floor prices are fundamentally incompatible with the core ETS design as a volume-based instrument combined with free price formation.** The market is already being strengthened during Phase IV and this will continue on the road to carbon neutrality by 2050. The carbon price floor discussion to address scarcity and a persistent fall in carbon prices has now become a debate of the past.<sup>10</sup>

As rightly noted in the U.S. Commodity Futures Trading Commission (CFTC) report *Managing Climate Risk in the U.S. Financial System*, "*Financial markets will only be able to channel resources efficiently to activities that reduce greenhouse gas emissions if an economy-wide price on carbon is in place at a level that reflects the true social cost of those emissions. [...] In the absence of such a price, financial markets will operate suboptimally,*

<sup>10</sup> Detailed position on minimum carbon pricing can be found [here](#).

and capital will continue to flow in the wrong direction, rather than toward accelerating the transition to a net-zero emissions economy.” **This price signal is to be undistorted, economy-wide and trusted.**

Finally, market failures such as not taking into account carbon as externality, unaddressed and exacerbated by government failures, prevent an appropriate market response to the challenge of mitigating climate change. While the most important measure is to price carbon adequately, removing carbon subsidies may be equally important.<sup>11</sup> **Critically, governments should consider the overall net impact of existing taxes, subsidies and mandates in relation to a carbon price to mitigate unintended economic dislocations.** This is notably the case when the road transport and buildings sectors would be included in the EU ETS.

## **5. Global cooperation in carbon pricing and carbon diplomacy need to be intensified to preserve European competitiveness**

**The EU ETS is still the largest and most important cap and trade system in the world. Any regulatory adjustments are likely to be widely noted and hence significantly influence global emissions trading.** Over the last few years, we have seen a rapid increase in carbon pricing globally, in particular in form of emissions trading schemes. There are now 21 systems covering 29 jurisdictions with an ETS in force. While significant differences in policy exist globally, the global policy landscape is gradually moving closer towards the vision of global carbon pricing. This also offers significant potential for cooperation between different trading schemes.

We therefore welcome the European Commission’s increased focus on climate diplomacy as it will strengthen the European Union in at least the following ways:

**First, pricing carbon globally is the most cost-effective abatement method as well as most efficient remedy against carbon leakage thus preserving European competitiveness.** EEX agrees on the need to address possible carbon leakage from the European Union, as well as support European businesses competing in the global market by creating a level playing field across jurisdictions. A CBAM as closely integrated with the EU ETS as possible can be a transitional tool towards equivalent domestic carbon pricing systems. The Energy Community for example increasingly looks into carbon pricing options for its Contracting Parties, partly following the carbon border measures announced by the EU.<sup>12</sup> The desirable long-term outcome is one in which such mechanisms are no longer needed.

The ability of carbon markets to help identify cost-effective mitigation actions is not only helpful in lowering the economic cost of meeting current ambitions but can also play a powerful role in facilitating countries to take up more ambitious mitigation targets in the years ahead. This is notably relevant in light of the new US Biden-Harris administration who has marked the climate emergency as one of their core priorities. In addition, earlier in 2020, international linkage was achieved between the EU and Switzerland; an agreement that will clearly benefit both. This linkage proves that it can be done and provides a framework for negotiation and cooperation with other countries e.g. the United Kingdom

**Second, the EU ETS as leading system has the potential to bolster the euro a default currency for the denomination of sustainable instruments.** In this context, we support the Commission’s intention to expand the international role of the Euro in sync with the role of the EU ETS to maximize its environmental outcome and support further ETS trading activity in the EU.<sup>13</sup>

EEX Group takes Beyond Europe, EEX takes a global perspective on carbon pricing and is actively supporting emissions market developments in New Zealand and China in collaboration with local partners. In North America, EEX Group’s Nodal Exchange, in cooperation with IncubEx, develops and offers a wide range of environmental products for the North American market including trading in California and RGGI carbon allowances.

<sup>11</sup> IMF working paper: Macroeconomic and Financial Policies for Climate Change Mitigation: A Review of Literature, 2019 [link]

<sup>12</sup> A carbon pricing design for the Energy Community Final Report, 2021 [link]

<sup>13</sup> European Commission Communication The European economic and financial system: fostering openness, strength and resilience COM(2021)32 final [link]

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