Fit for 55: A carbon pricing upheaval

Exploring 'Fit for 55' and challenges to the EU's climate ambitions

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Key points

- The European Commission (EC) has unveiled a suite of measures, known as 'Fit for 55', to help deliver the European Union (EU)'s Green Deal objective of at least a 55% reduction in greenhouse gas emissions from 1990 levels by 2030.
- The core of the proposals relies on carbon pricing. In this report, we explore the underlying mechanisms of the EU Emissions Trading System (ETS) and the Carbon Border Adjustment Mechanism (CBAM).
- Phase 4 of the EU ETS revision (2021-2030) introduces more ambitious emissions reduction targets, extends the system to aviation and shipping and creates a new ETS scheme for fuels in road transport and buildings.
- The EC also proposed phasing in a CBAM from 2023 to 2026. This would apply to sectors with a high risk of carbon leakage – iron and steel, cement, fertiliser, aluminium and electricity generation.
- Carbon pricing also raises revenues. We discuss the different initiatives proposed by the EC to increase its financing capacity and smooth the financial impact on the most vulnerable households.

"Fit for 55"

The European Union (EU) wants to remain a leader in climate action and policies. The EU Green Deal, adopted in January 2020, commits to reducing the bloc's greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels, and reaching carbon neutrality in 2050. In a previous paper[1], we highlighted the challenges faced by the EU, exposed the financing need and how the Next Generation EU package can respond to it. This was a big step, but acts as a catalyst for further reforms, especially for carbon pricing.

Carbon pricing is a means of internalising the negative externalities caused by greenhouse gases. If the system is well designed, it should adjust the relative price of goods to allow for their carbon content and hence modify economic behaviours and incentivise investments for a greener economy.

On 14 July, the European Commission (EC) unveiled a suite of measures known as 'Fit for 55', including a comprehensive carbon pricing strategy, to achieve the EU Green Deal target of reducing emissions by 55% by 2030. It encompasses a revision of the current Emissions Trading System (ETS) and stricter regulations, a more ambitious emissions reduction target and the proposal of a Carbon Border Adjustment Mechanism (CBAM).

[1] Menut, A., "Europe's path to net zero", AXA IM Macro Research, 12 May 2021

This report discusses the main tools of the EU carbon pricing system, namely the ETS and CBAM, its geopolitical background and the potential redistribution of these new carbon revenues. However, these proposals have not yet been adopted and tough discussions will be held with internal and external partners. On an EU level, they must be endorsed by both the European Council and the European Parliament, and negotiations will also take place with lobbies, third-party countries and the World Trade Organization.

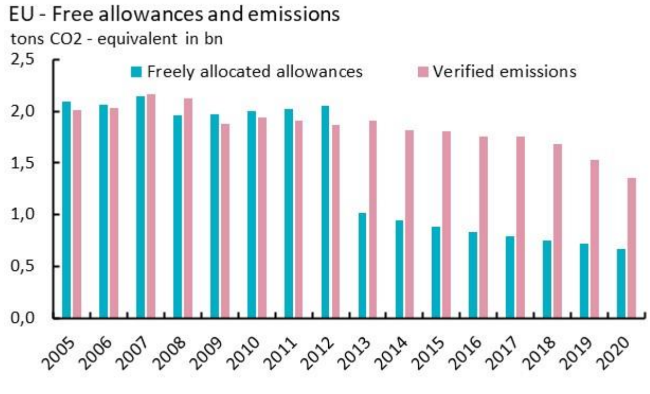
Why an ETS scheme?

The EU Emission Trading System was introduced in 2005 and covers approximately 10,000 installations in the power and manufacturing industries, as well as airlines operating in the EU. It currently applies to about 40% of the EU's greenhouse gas emissions.

The theory of the ETS is simple enough. The EU caps the total amount of emissions permitted by companies in the power and heat generation, aviation and energy-intensive industrial sectors. Companies within these sectors must purchase emission permits via auction and can use, trade or keep them for the following year. If a company is unable to cover its emissions, it bears a heavy penalty. The total cap is then reduced over time, in line with the EU's emission reduction strategy.

One caveat is 'free allowances'. The EU provides a given amount of 'free allowances' to shield domestic companies from international competition and avoid relocation of polluting activities outside the EU (carbon leakage). At the beginning of Phase 3 (2013-2020), free allowances represented 80% of new permits but this has decreased to 30% in 2020 (although aviation is still completely covered by free allowances) (Exhibit 1).

Exhibit 1: In 2020, free allowances accounted for half of verified emissions



Source: European Environment Agency and AXA IM Research, as of 2020

In response to a considerable surplus of allowances – a consequence of the slump in activity in 2008-2009 and high imports of international credits[2] – which distorted the price signal, the EC created a Market Stability Reserve (MSR) in 2019. This does not allow discretionary intervention, but automatically places allowances in the reserve, or releases them, in case pre-defined thresholds are crossed. This should help fix the carbon price within a certain range.

The EU ETS revision

Phase 4 of the EU ETS revision (2021-2030) introduces a more ambitious emissions reduction target – the total cap will adjust by -4.2% each year from 2.2% previously, alongside a one-off reduction on the overall emissions cap. It will also address any misallocations associated with the free allowances.

The number of free allowances should decline slightly before 2026 and faster thereafter, decreasing by 10% annually over 10 years. The rules to allocate free allowances have not changed and will be based on benchmarks representing the level of performance of the best installations. Free allocation will be made conditional on decarbonisation efforts while installations using low-carbon technologies may also continue to benefit from free allocations. Lastly, the EC suggests slight changes in the MSR rules to smooth the placing of allowances in the reserve in case market surpluses are close to the threshold.

The Commission is also proposing to add new sectors to the ETS where sharper reductions are needed – aviation and shipping. For the aviation sector, the EC proposes to gradually remove the free emissions allowances and to move to fully auctioning allowances in 2027. For maritime transport, only large ships (cruise ships and merchandise transport) would be affected, accounting for approximately two-thirds of EU CO_2 emissions in maritime transport.

By 2026, the EU will also create a new ETS scheme to include fuels used in road transport and buildings. Suppliers would be responsible for monitoring and reporting the quantity of fuels they sell on the market, multiplied by the respective carbon content of fuels. Interestingly, this new ETS proposes a specific mechanism to contain excessive increases in the carbon price[3], and this is probably the main reason behind the separation with the original ETS.

In conclusion, free allowances will remain abundant in the coming years, while conditionalities remain soft. The incentives may not be as strong as expected – especially as the EC proposes to introduce a CBAM from 2026, providing double protection for some heavy polluters. We believe uncertainties over the CBAM's adoption have probably

[2] Industrialised countries received international credits, which represents a tonne of carbon dioxide (CO_2), when they invested in projects reducing CO_2 in developing countries. Between 2013 and 2020 (Phase 3), those products needed to be exchanged within the EU ETS.

[3] To mitigate a potential risk of excessive price increases, the MSR would operate in this new ETS and may release allowances from the reserve under certain conditions.

forced the EC to be cautious about the end of free allowances, so it does not endanger EU competitivity.

Is the Carbon Border Adjustment Mechanism a panacea?

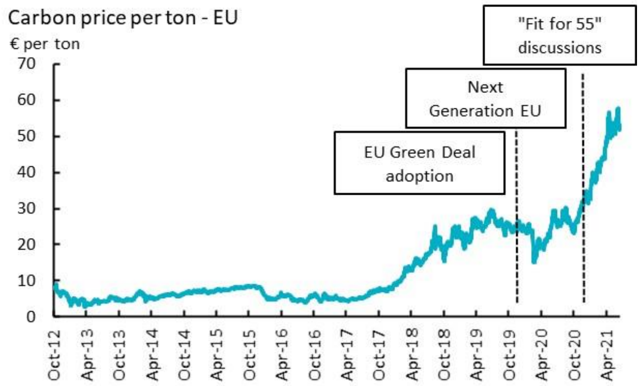
The CBAM addresses the risk of carbon leakage by adding back in the cost of the carbon content of products imported into the EU. It is an environmental policy measure that protects the EU's climate policy, preserves the domestic economy from unfair competition and incentivises exporters to the EU to adopt cleaner production processes.

In more practical terms, the CBAM will mirror the ETS. EU importers will purchase permits corresponding to the carbon price that would have been paid if the goods had been produced in the EU under the domestic carbon pricing rule. Conversely, if a non-EU producer proves that it has already paid a carbon tax in another country, the corresponding cost can be fully deducted for the EU importer.

A CBAM is already in place in some parts of the world, such as California, and countries like Canada and Japan are planning similar initiatives. But as it stands, the EU CBAM should probably be perceived as essentially a negotiation tool, for now at least. A transition phase will run from 2023 until 2026 with the objective of improving data collection, smoothing the roll out and facilitating dialogue with third-party countries and the World Trade Organization.

The debate over CBAM has intensified in recent years and new pledges by different countries to achieve carbon neutrality are not trivial. The sooner those countries act, the sooner the differential between the EU carbon price and others will fall and the less they would be impacted from a trade perspective (or the more chances they can be exempted)[4]. For example, China has just started trading of emissions permits covering more than 2,000 energy-producing plants. However, China appears to have repeated the EU's initial mistake (Exhibit 2). Due to an oversupply of permits, the Chinese carbon price is currently too low (standing at $7). In the US, Democrats are also eyeing a carbon border tax to help fund President J. Biden's spending package. But for multiple reasons, we do not expect the US to adopt a carbon border tax any time soon, although there is at least a rising debate.

Exhibit 2: Carbon price surged in light of the 'Fit for 55' discussions



Source: Datastream and AXA IM Research, as of 16 July

Now, let's come to the tactical point. The EU CBAM will only apply to those goods with a high risk of carbon leakage – iron and steel, cement, fertiliser, aluminium and electricity generation, which together account for approximately 5-10% of EU imports and around 30% of worldwide CO_2 emissions[5]. This initial list likely reflects a European ambition to bring others along with it – particularly major trade partners including China and the US – rather than clash. The EC is maintaining additional pressure by highlighting the possibility of extending the scope of the scheme to wider products and services at the end of the transition phase (for instance electric equipment and automobiles), clearly setting out future intent. This acts a bit like forward guidance in the realm of monetary policy. An objective is set, together with instruments offering a path to achieving it, building up incentives and proof of goodwill.

Specifically, future discussions with Russia and Turkey will probably be more problematic as neither has set firm climate objectives and both are large exporters of high carbon content products (Exhibit 3). For the least developed economies, the EC did not disclose any specific rules but stands ready to "work with them towards the decarbonisation of their manufacturing industries and provide technical assistance". It is unreasonable to expect businesses in poorer countries to pay the same carbon price as richer countries even if it is consistent with avoiding carbon leakage. A minimum threshold on imports may help some countries – under the condition that larger exporters do not split shipments to avoid taxes. Negotiations will likely be lengthy, given global repercussions and a lot of idiosyncratic cases.

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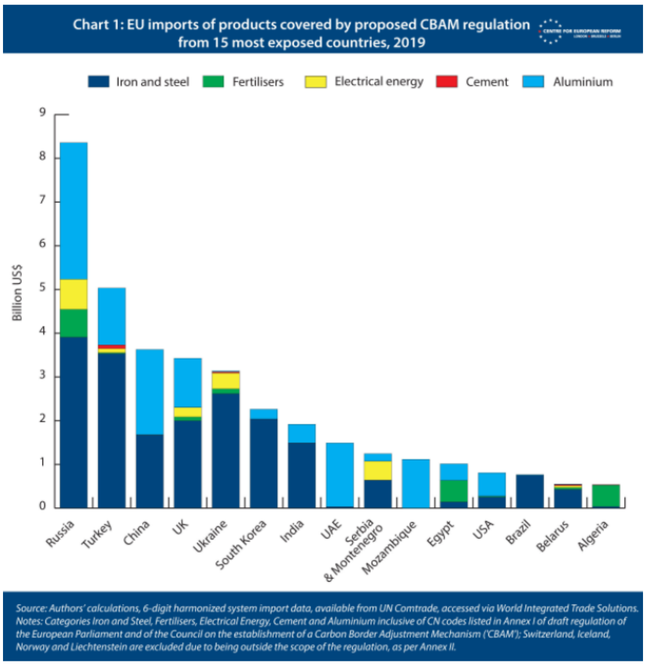
[4] Only Switzerland has an ETS linked to the EU but Norway and Iceland are very likely to be included.

[5] In details, iron and steel aluminium accounts for 7.9% of total greenhouse gas emissions, cement for 3%, fertilisers for 4.1% and electrical energy for 13.6% (which takes into account fugitive emissions from coal, gas and oil). Source: Our world in data

Exhibit 3: The impact of CBAM is heterogenous among trade partners



Source: Centre for European Reform as of July 2021

How will the revenues be used?

A beneficial side-effect of carbon pricing instruments is being able to raise revenues that can help finance the energy transition or redistribution. Auction revenues from ETS go mainly to member states' budget (approximately €14bn-16bn annually) and are essentially reinvested into climate- and energy-related purposes – 70% on average so far, with proceeds due to be fully invested in climate-related projects going forward. Additionally, the current ETS finances an Innovation Fund which supports breakthrough innovations towards climate neutrality and a Modernisation Fund for power sector upgrades in lower-income member states[6].

The EC proposes to increase the revenues for those funds. The Innovation Fund, which currently has €450m of allowances for 2021-2030, would receive an additional €200m of allowances, while the Modernisation Fund, endowed with 2% of total allowances currently, would receive an extra 2.5% for 2021-2030. Revenues will depend of the price of carbon but the total budget at the current price of €50 would be close to €32.5bn for the Innovation Fund and €14bn for the Modernisation Fund. Those proposals are welcome, but it does not entirely solve the issue of the east/west climate divide across member states. If we add up financing from Innovation and Modernisation Funds, Central and Eastern European countries should proportionally receive more. But some countries like Poland still rely heavily on fossil fuels (in 2018, 44% of electricity produced there came from hard coal, and 30% from oil). Financing needs remain extremely important but some countries, such as Spain in the 2000s, or Slovakia in the beginning of 2010s, have shown that coal reduction at the same stage of development was possible.

The EC also confirmed that it would use future CBAM revenues to reimburse a share of the mutual debt raised by the EU in the Next Generation EU plan.

A socially fair transition?

ETS, CBAM and more generally all the measures to tackle climate change will inevitably place extra pressure on vulnerable households, micro enterprises, and transport users. Although the benefits of the current EU strategy in the medium-to-long term will likely outweigh the costs of transition, the question of social acceptability is important, with several past instances of public rejections of environmentally friendly tax changes in the Eurozone.

The EC proposes a Social Climate Fund with dedicated funding to member states to help citizens finance investments in energy efficiency and cleaner mobility. Revenues would come from the new ETS for building and road transport fuels and should approximate 25% of ETS revenue (€72.2bn in 2025-2032). Yet those transfers would not be 'direct'. The EC suggests that countries design their own actions to mitigate the social impact and then seek financial support from the fund money. Some conditionalities with pre-defined targets on decarbonisation efforts are likely to be included. For example, if transfers were concentrated on the last quintile of income distribution, it would represent only €100 per year per head, highlighting the importance of domestic actions on top of the EU efforts.

Still an ongoing project

Both the ETS revision and CBAM launch send strong signals about the EU's intention to transform industry domestically but also take a lead in shaping developments on a global scale. As of now though, those initiatives are only proposals and will take several years to convert into actual policies, requiring joint approval by the European Parliament and EU countries.

Moreover, the CBAM proposal is quite striking. It is described in heavily diplomatic terms, applies to limited sectors, is very gradual in implementation and details no explicit redistribution other than to the EU budget. As such, it appears for the time being more as policy designed to buy time and apply pressure to international competitors to establish concrete negotiations rather than a policy fully designed for implementation. Discussions over the coming years with sector lobbies, member states, third countries and the World Trade Organization are likely to prove challenging and shift any final mechanism from this initial proposal. But the measures announced in July begin those discussions.

[6] The Modernisation Fund supports 10 countries: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia

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