EU Sustainability Initiatives Will Affect Emissions Trading

By **Melanie Bruneau, Giovanni Campi and Annette Mutschler-Siebert** (July 7, 2023)

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In recent years, the European Union has announced and adopted a wave of sustainability initiatives that will have significant implications for non-European as well as European companies across all industries.

Among other measures, the EU institutions have stepped up their legislative activity, aiming to achieve climate neutrality in 2050 through promoting sustainable and responsible environmental behaviors, not only by EU member states and European businesses, but also by non-EU countries and companies.

In this context, the European co-legislators — the European Parliament and Council of the EU — adopted the directive revising the EU emissions trading system, or EU ETS,[1] and the regulation establishing a carbon border adjustment mechanism, or CBAM.[2] The CBAM is designed to reflect and complement the EU ETS on certain imported goods.

These are key elements of the "Fit for 55" legislative package, initially proposed by the European Commission in July 2021, which aims to reduce EU greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels, and achieve climate neutrality by 2050 in line with the European Green Deal.[3]

Within the framework of the Fit for 55 package, the co-legislators have also approved revisions to the ETS Aviation Directive,[4] the amendment of the Monitoring, Reporting and Verification Shipping Regulation[5] and the regulation establishing a social climate fund.[6]

These laws have far-reaching implications for global climate and energy interests in general, and in particular for global companies that need to implement changes in order to offset potential impacts of their business operations.

In line with the objectives presented by the commission for the European Green Deal, there is not a single company or sector of the economy that is not concerned or affected by the EU sustainability initiatives.

Obviously, certain sectors have been identified as having a greater impact on the environment and will therefore have to adapt to new and stricter rules earlier than others to make the European Green Deal a reality.

The aviation and maritime industries and other industrial sectors — in Europe and beyond — will have increased responsibility to pay for their carbon footprint and to accelerate their transformation toward lower emissions.

The upcoming changes will apply gradually — thus affected companies need to monitor the revised legislative framework closely to be prepared to comply with their growing and more stringent obligations.

The introduction of new obligations to offset carbon emissions will be a disadvantage for companies who are currently emitting a great deal of carbon dioxide and not offsetting that in any way and an advantage for those who are already working on reducing or offsetting their emissions.

Revisions to the EU ETS

In place since 2005, the EU emissions trading system is a carbon market based on the cap-and-trade of emission allowances for certain energy-intensive industries and the power generation sector. Under this scheme, the overall volume of greenhouse gases is limited by a cap that will decrease every year.[7]

Companies in the targeted sectors need to buy or receive a European emission allowance for every tonne of CO_2 or the equivalent amount of other powerful greenhouse gases — nitrous oxide and perfluorocarbons — that they emit each year.

After each year, companies must surrender enough allowances to cover their full emissions and could otherwise be subject to fines. When a company reduces its emissions, it can keep the saved allowances to cover its future needs or sell them to other companies that are short on allowances.

The aim is to incentivize companies to ultimately reduce their emissions by investing in energy efficiency.

The allowances are distributed per member state and are bought through auctions. However, in specific sectors, where there is a high risk of carbon leakage, i.e., the shift of production to countries with less ambitious emissions reduction policies, the allowances may be allocated to companies for free under certain conditions.

Such free allowances are reduced along with the overall reduction of the emissions cap. The cap decreases every year, ensuring that total emissions fall progressively.

The newly revised EU emissions trading system directive aims to accelerate the pace at which sectors covered by the EU ETS are required to decarbonize, increasing the EU emissions reductions target to 62% by 2030, up from the 41% achieved since it was first introduced in 2005.

The revision of the EU emissions trading system provides for the decrease of the overall quantity of emission allowances and for the increase of the cap's annual reduction rate per year.

Implications for the Aviation Sector

Emissions from the aviation sector have been included in EU emissions trading system since 2012. The EU emissions trading system applies to intra-European flights.

All airline operators, European and non-European, operating international flights on routes to, from or between EU airports, are required to monitor, report and verify their emissions, and to surrender allowances against those emissions. Airline operators receive tradable allowances covering a certain level of flight emissions per year.

The latest revision provides that the EU emissions trading system continues to cover intra-European Economic Area flights, including flights to and from the U.K. and Switzerland, while the Carbon Offsetting and Reduction Scheme for International Aviation, or CORSIA, will apply to international aviation.

The baseline for offsetting extra-EEA flights with CORSIA credits is set at 85% of the 2019 emissions level.

In 2026, the commission will evaluate whether CORSIA meets the objectives of the Paris Agreement and, if CORSIA is considered insufficient, it will decide whether a proposal to extend the EU emissions trading system to extra-EEA flights is needed.

Free emission allowances will be gradually phased out and full auctioning will be implemented from 2026.

The requested monitoring regulation framework for non-carbon dioxide emissions from aviation must be implemented by 2025 and evaluated in 2027. In 2028, following an impact assessment the commission can put forward a proposal to address non-carbon dioxide emissions from aviation.

The directive was published in the Official Journal of the EU on May 16, and entered into force on June 5.

New Rules for the Maritime Transport Sector

The scope of the EU ETS has now also been broadened to include emissions from maritime transport for the first time. Shipping companies must surrender 40% of allowances for verified emissions from 2024 onwards, 70% from 2025, and 100% from 2026.

At this stage, most large offshore vessels — ships of at least 5,000 gross tonnage — will be included in the monitoring regulation from 2025, and will be included in the EU ETS as from 2027.

Remaining large vessels, i.e., offshore vessels — ships between 400 and 5,000 gross tonnage — will also be included in the monitoring regulation as from 2025, but will be included in the EU ETS at a later stage.

As a result, shipping companies will have to allocate a number of allowances to account for:

- 50% of the emissions from ships performing voyages departing from a port of call in the EU and arriving at a port of call outside the EU and vice versa — extra-EU voyages;

- 100% of emissions from ships performing voyages departing from a port of call in the EU and arriving at a port of call in the EU — intra-EU voyages; and

- 100% of emissions from ships that are at berth in EU ports.

To ensure a smooth transition of the sector into the EU ETS, the surrendering of allowances by the shipping companies is conceived to be gradually increased with respect to the verified emissions reported for the years 2024 — 40% of emission in the scope — and 2025 — 70% of the emission in the scope).

From 2026, shipping companies will have to surrender the number of allowances corresponding to all of their verified emission in the scope.

In addition, until 2024, the target shipping companies will have to account for CO2 emissions only and starting from 2026 also for methane and nitrous oxide in light of the expected growing development of vessels powered by liquefied natural gases or other energy sources.

Additional Scheme for Other Sectors

A new separate emissions trading system for greenhouse gas emissions derived from fuels used in buildings, road transport, and in certain additional sectors[8] will also apply as of 2027, unless the oil and gas prices rise to exceptional levels in the years preceding 2027.

In that case, a safeguard provides that the application of the emissions trading system could be pushed to 2028.

Support for Vulnerable Households, Micro-Enterprises and Transport Users

In an effort to address social effects deriving from this specific system, the regulation establishing the social climate fund provides that EU member states will be able to use the fund to finance temporary direct income support for vulnerable households, and to support measures and investments that reduce emissions in road transport and the buildings sector. This will benefit vulnerable households, microenterprises and transport users.

CBAM

Objectives of the Carbon Border Adjustment Mechanism

The CBAM aims to ensure that the carbon price for certain imported goods is equivalent to the carbon price paid for EU products operating under the EU ETS, in order to reduce the risk of carbon leakage and to promote a level playing field for a targeted number of sectors.

The CBAM is designed to reflect and complement the EU ETS on such imported goods.

For production outside the EU, EU importers will have to purchase CBAM certificates for the difference between the carbon price in the country of production and the price of carbon allowances in the EU ETS.

The CBAM will therefore essentially impose a tax on imported energy-intensive goods that correlates to the price of emissions allowances on comparable domestic industries under the EU ETS. In-scope importers must become authorized CBAM declarants, obliged to purchase and surrender CBAM certificates.

Sectors in Scope of the CBAM

The energy-intensive goods that will initially fall under the scope of the CBAM include:

- Iron and steel;
- Cement;
- Fertilizers;
- Aluminum;
- Electricity; and
- Hydrogen, as well as certain precursors and downstream products.

The commission will adopt implementing acts to further specify the scope of the CBAM. In this context, the commission could decide to broaden the CBAM's scope to include products further down the value chain.

Moreover, the CBAM will also cover indirect emissions, that is, carbon emissions linked to the consumption of fossil electricity, under certain conditions. Overall, in-scope sectors represent between 50% and 60% of the EU's industrial carbon footprint.

Companies in Scope of the CBAM's Obligations

Under the CBAM, undertakings in scope will have to purchase and surrender CBAM certificates to cover the embedded carbon content in the products, unless they can prove that such carbon emissions have already been covered by the relevant legislation in the producer's country.

Prior to that, they will have to become authorized CBAM declarants and set up a CBAM account in each member state where they import goods under the levy's scope, and on a yearly basis, they must provide each member state with the number of certificates corresponding to the level of carbon emissions embedded in the products imported.

Application Timeline

The CBAM will apply as of Oct. 1, with a transitional period until the end of 2025, where importers will only have to comply with reporting obligations.

As of 2026, the CBAM will be phased in, while the EU ETS will be simultaneously phased out for sectors now covered by the CBAM. By 2034, the EU ETS will no longer apply to the sectors covered by the CBAM.

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[1] The EU ETS Directive entered into force on 5 June 2023.

[2] The CBAM Regulation entered into force on 16 May 2023.

[3] https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal_en.

[4] The EU ETS Aviation Directive entered into force on 5 June 2023.

[5] MRV Shipping Regulation entered into force on 5 June 2023.

[6] The Regulation establishing a Social Climate Fund entered into force on 5 June 2023.

[7] The EU ETS covers approximately 10,000 companies, including electricity and heat generation, energy-intensive industry sectors (e.g., oil refineries, steel industry, cement, glass, and paper production), and commercial aviation (flights within the European Economic Area).

[8] Additional sectors that correspond to industrial activities not covered by Annex I to Directive 2003/87/EC, such as the heating of industrial facilities.