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The future of carbon pricing

EVENT REPORT

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This report reflects the conversation during the Friends of Europe policy insight event, entitled 'The future of carbon pricing', that took place online on 14 March 2022.

For the European Union to achieve its ambitious goals of reducing emissions by 55% by 2030 and becoming climate neutral by 2050, the Emissions Trading System (ETS) is currently being revised. Industry executives have been experiencing increasing urgency to take stronger climate action, and a growing number of stakeholders are calling for greater predictability to reduce the risks and foster low carbon, capital-intensive investments. After reaching an all-time high of €97 per tonne in early February, the EU carbon price has experienced a steep decline following the Russian invasion of Ukraine. On 14 March, the price was back on an ascending path, with the value of €79.37. At the same time, the prices of electricity and gas are soaring, with considerable energy security concerns.

In this context, the European Parliament and Council have the difficult task of developing their positions on the Commission's proposal to extend carbon pricing to the building and road transport sectors. That might impact families that rent their homes, live in social housing, or are stuck with petrol cars. How should the co-legislators' positions be shaped in the context of increasing energy prices and energy security concerns? How can carbon pricing help the EU achieve its 2030 climate targets without losing sight of Europe's equality and solidarity principles?

Speakers and participants considered the following questions:

- What should policymakers do to make the current carbon pricing proposals central to efforts to reduce emissions by at least 55% this decade?
- How should the ETS be shaped in the context of fluctuating energy prices and security of supply concerns caused by the war in Ukraine?
- How can we address potential distributional effects of carbon pricing among member states, sectors and citizens?

Speakers

The debate was moderated by Dharmendra Kanani, Friends of Europe's Chief Spokesperson and Director for Digital, Asia, and Peace, Security & Defence, with the following speakers on the panel:

Adrien Assous
Delegated Director of Sandbag

Alexandre Marty
Head of Climate and Natural Resources at EDF

Peter Wittoeck
Head of Climate Change at the Belgian Federal Public Service Health, Food Chain Safety and Environment

Beatriz Yordi
Director for Carbon Markets and Clean Mobility at the European Commission Directorate-General for Climate Action

The way forward

During the event, several suggestions emerged on the way forward for carbon pricing and the wider climate and energy debate, particularly in the context of the energy crisis exacerbated by the war in Ukraine:

- Refrain from intervening in the ETS market to mitigate volatility of energy prices.
- Ensure a price corridor to mitigate any sharp price rises.
- Ringfence ETS revenue for member states to help them tackle social aspects of the energy crisis.
- Continue apace with the sustainable transition as a means to decouple Europe from Russian fossil fuels.
- Remove the system of free allocations with the introduction of the Carbon Border Adjustment Mechanism (CBAM).
- Ensure that the environmental benefits of green hydrogen are properly rewarded and remove unjust awards for grey hydrogen.

Event summary

During Friends of Europe's 14 March policy debate on the future of carbon pricing, speakers from the European Commission, member states, think tanks and industry discussed how the EU's Emissions Trading System (ETS) could be improved in the context of rising energy prices and geopolitical challenges.

"Whilst the EU carbon price peaked this February, it then slumped following the invasion of Ukraine and is now getting back," said moderator and Director at Friends of Europe, **Dharmendra Kanani**. "It feels as if it's all over the shop. There is no reliability or predictability about gas or energy supply, and we are looking at a precipice of huge amounts of poverty, especially amongst the most vulnerable communities."

"We need to insist that the Green Deal is a path for independence from fossil fuels," said **Beatriz Yordi**, Director for Carbon Markets and Clean Mobility at the European Commission Directorate-General for Climate Action. "Carbon pricing is a pillar on the decarbonisation path, and this path has enormous advantages for the security of supply," she continued.

Alexandre Marty, Head of Climate and Natural Resources at EDF, said that the ETS "works quite well in the way it is structured" at present. "We mustn't add unpredictability to this already unpredictable context," he cautioned. "We should refrain from the temptation of intervening [in] the ETS market to mitigate what we see today in terms of volatility in energy prices."

The use of ETS revenues

"If you introduce carbon pricing in any sector, you also introduce revenue for the authority," said **Peter Wittoeck**, Head of Climate Change in the Belgian Federal Public Service Health, Food Chain Safety and Environment. He recalled that according to the Commission's proposal to expand the EU ETS to road transport and buildings, around 25% of the revenues should be distributed equitably among and within EU member states to the most economically vulnerable groups via the Social Climate Fund.

"The system itself has the potential to compensate for any unwanted distributional impacts both between member states and certainly within member states and income groups," he continued. He also added that a "price corridor" can increase predictability and avoid "excessive price peaks" that would be caused by the carbon price itself.

Wittoeck gave the example of a Belgian proposal for each household to be provided with a lump sum generated from the carbon price, in which richer households would receive less than they pay and poorer households would receive more.

"We must get rid of the misconception that the carbon price is a major part of the problems we are facing now," he said, explaining that the energy crisis "boils down to spikes in gas price".

"Nothing prevents you from dealing with the social aspects of the energy crisis using ETS revenues," he continued. "You can still use the revenue that is being generated to compensate for the spikes in the gas price."

He explained how Belgium is already ringfencing this money, with part of the revenue set to go to societies that need it. “Ringfencing is definitely an essential part of the solution,” he concluded.

However, **Adrien Assous**, Delegated Director of Sandbag, added that only a small amount of the ETS revenue currently goes to member states. “A lot of social policies can be implemented but that will depend on the amount that is remaining,” he said.

The need to tackle the EU ETS free allocations

Assous criticised the current ETS system of free allocation permits, saying that they are obstacles to decarbonisation and innovation, and that they increase market volatility. “There are a lot of problems around the carbon market linked to the allocation method,” he said.

Assous explained that free permits are an obstacle to decarbonisation, giving the example of how cement in concrete receives a subsidy thanks to the free permits allocated to cement, and that the carbon to produce the concrete is therefore not taken into account.

Free allocations are also an obstacle to innovation, he said, adding that green hydrogen (i.e., produced from surplus renewable energy sources, such as solar or wind power, to split water into two hydrogen atoms and one oxygen atom through a process called electrolysis) should be more profitable than grey hydrogen (i.e., generated from natural gas or methane, through a process called ‘steam reforming’). “The problem is that the latter benefits from free permits, so if you have a grey hydrogen facility, it can remain profitable.”

Lastly, free allocation creates a problem in the market because the latter “becomes highly volatile when everything is going well, and even with high prices there is no response in the market because industry gets their permits for free”.

“As soon as things go badly, there is a lot of [surplus] created that can be dumped on the market and lead to crashes,” he said. “Free allocation should be tackled very urgently,” he warned, adding that the Commission’s proposed CBAM could be a success, as long as it does replace these free allocations.

Sustainable transition: the time is now

President of the Finnish Innovation Fund Sitra and former European Commission vice-president for jobs, growth, investment and competitiveness, **Jyrki Katainen** intervened to say that the current war in Ukraine adds further impetus to the green transition. “No one wants to be dependent on Russian fossil fuels,” he said, adding that there is no reason to change direction.

“On the contrary, we have momentum now, and there are even stronger arguments to become more sustainable in energy production.”

“We cannot change everything overnight,” he continued, “but in three years we can be very far in the sustainable transition if we start it right now. The energy market is also changing, and there are new incentives for the private sector to invest in technologies that weren’t as profitable before the crisis.”

"We have a fantastic opportunity to accelerate the deployment of renewables and the electrification of the economy," said Marty, who advocated for targets for clean mobility and energy renovation when it comes to direct electrification, as well as for enabling indirect electrification by scaling up hydrogen in the 'hard to abate' sectors.

He noted that the latest report from the Intergovernmental Panel on Climate Change argued that strong and urgent mitigation is needed for adaptation to be possible.

"When you decarbonise, you will need more electricity," added Assous. He explained that hydrogen will be needed for uses that cannot be electrified and said that nuclear power plants could also be an option as they are "better than oil and gas".

Conclusions

Concluding the discussion, Yordi said that of the 155mn cubic metres of gas that the EU imports from Russia, 100mn can be removed as a result of the Green Deal.

On the use of revenues from the ETS, she argued that the Commission has tried to include more transparency, explaining that the new proposal for the ETS stipulates that 100% of revenues should be used for climate purposes. "It's not that we are waking up now," she said. "We have reduced our emissions by 40% since the nineties in the ETS sectors."

Acknowledging that the free allocations have been a "measure to protect our industry from trade exposure", she confirmed that by implementing the proposed CBAM, the system of free allocation would be taken out.

She agreed with the comments made about the discrepancies between green and grey hydrogen, noting that there was a "need for equivalence by product".

Yordi concluded by saying that a quarter of free allocation quotas "depends on conditionality, meaning that industries must invest in measures".

"When we talk about social regression, the Green Deal is compatible with progression," she said, recalling that 20% of the poorest households are responsible for 9% of emissions from transport, whilst 20% of the richest households are responsible for 30% of emissions.

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