Brussels, 27 September 2022

EU Emissions Trading System and Market Stability Reserve reviews: cost-effective carbon emissions reduction in the new context

Cepi's recommendations for the trilogues

Cepi represents the European pulp and paper industry and gathers, through its 18 member countries, some 885 pulp, paper and board mills across Europe directly, employing more than 180,000 people. Our sector is investing at a rate of more than €5 billion per annum, increasing production volumes while simultaneously reducing our carbon footprint.

The European pulp and paper industry fully supports the EU objective to reach climate neutrality by 2050. We have already achieved a 36% reduction of carbon emissions from 2005 to date. From an energy perspective, our sector is in a unique position. We are:

- The fourth largest industrial user of energy and the second industrial electricity consumer in Europe
- The largest biomass industrial user, accounting for more than 60%[1] of our fuel, coming from side streams of our activities
- One of the leading sectors in using renewables in industrial heating

As the EU Emissions Trading System (ETS) and Market Stability Reserve (MSR) reviews enter the next stage of negotiations, Cepi encourages the negotiators to use this opportunity to retain the regulatory stability as agreed for the EU ETS phase 4. The three EU institutions should strive to:

1) Consider the drastically changed circumstances to ensure cost-effectiveness of the EU ETS

The Impact Assessment (IA) accompanying the proposals for the revision of the EU ETS Directive and the MSR Regulation was published in July 2021, in completely different circumstances. The Commission's model foresees that strengthening the ETS cap would lead to the price of €60/European Union Allowance (EUA) (page 90). In reality, the EUA price did not fall below €75 between early March and early September 2022.

When it comes to fuel price assumptions, the Commission projects international fuel prices. Whilst the IA shows an oil price of $72.2/80.1 per BOE (page 48), the August Oil Market Report[2] by the International Energy Agency reports that, at the time of writing, ICE Brent Crude futures were around $97/BBL while NYMEX WTI were trading at $92/BBL.

The Commission's IA also assumes that the power sector is expected to continue its fast decarbonisation and highlights that "the regulated phase out of coal power has the potential for a significant permanent reduction in EUA demand". In fact, some European governments decided to reactivate coal-fired power plants in order to face possible energy shortages.

It can be argued that energy costs will stabilise over time. Nevertheless, the current energy crisis will have a long-lasting impact on the pulp and paper sector's operations in Europe. These drastically changing circumstances only support that the call to avoid rebasing. Such a one-off cancellation of allowances could result in a severe shortage of allowances, leading to an artificial increase of CO_2 prices. Rebasing would increase the industry's costs for the same level of 2030 climate ambition.

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[1] Cepi (2022) Key Statistics 2021. European pulp and paper industry

[2] International Energy Agency (2022) Oil Market Report – August 2022

The MSR is working as expected. With the post-pandemic economic recovery, unforeseen changes in the power sector and increasing ETS ambition, a faster than expected absorption of allowances is anticipated, damaging the industry's ability to operate and invest in its decarbonisation.

Recommendations:

- **Avoid rebasing**. If unavoidable, the Parliament's proposal to split rebasing into two parts in 2023 and 2026 could be a fallback option to reduce the impact on the carbon market.
- **Avoid increasing the MSR intake rate**. The Commission's proposal to increase the intake rate from 12 to 24% until 2030 should be rejected.

2) Remember that the climate ambition level of the EU ETS is defined by the cap level, not by the speed of phasing out free allocation

The EU ETS cap defines the system's ambition to achieve the 2030 and 2050 goals. A faster phase out of free allocation only increases the risk of carbon leakage. In fact, a higher ambition level requires stronger carbon leakage protection measures. The Commission's proposal to sharply reduce free allocation by 50% before 2030 may make it unmanageable for many companies to invest in new technologies which allow them to significantly reduce their carbon emissions in the years to come.

Reducing free allocation should not punish the front runners of industrial decarbonisation. The premature benchmark update may severely reduce free allocation for our sector which is one of the largest industrial users and generators of renewable energy. The Commission's proposed maximum level of the benchmark fails to take into consideration the fact that the power sector may not decarbonise as fast as previously expected. Given that the decarbonisation trends may cease in the coming years, the benchmarks should not be updated at higher rates.

The conditionality proposed by the Commission further weakens carbon leakage protection. Free allocation is already conditional to meeting specific requirements such as trade and carbon intensity. The benchmarks, which are part of the free allocation formula, are already set at the level of the 10% best performing installations. The conditionality undermines the ETS architecture as a market-based system and turns it into a tool to micromanage the industry's operations.

Recommendations:

- **Maintain the current 1.6% benchmark update rate**. The Commission's proposal to increase the benchmark update rate from 1.6 to 2.5% per year should be rejected.
- Support the Council's position to **entirely reject any conditionality for free allocation.**

3) Maintain the technology-neutral approach to industry's decarbonisation pathways

The EU ETS must continue to reward investments in reducing carbon emissions, for example by switching to renewable energy sources such as biomass or biogas. Free allowances should be granted based on the product benchmark, regardless of how decarbonisation is achieved, and how high the resulting emission reductions are.

The Commission's proposal to exclude from the EU ETS installations where biomass contributes to more than 95% of the total energy sources contradicts the logic of supporting the industrial transition to renewable energy.

Recommendation:

- Support the Parliament's position to **entirely reject the exclusion of installations running on at least 95% biomass**

Contact person

Małgosia Rybak

Climate Change and Energy Director

Email: m.rybak@cepi.org, Mobile: +32 471 21 07 61