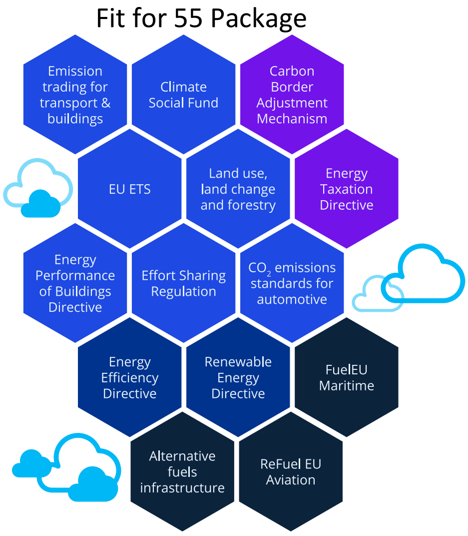
Fit for 55: Emissions Trading; Carbon Border Adjustments and Climate Funding

Provisional agreement on the trifecta

The EU continues with the rapid revision of existing, and the introduction of new, regulations to help ensure that it is well on its way to meet its 2030 climate ambition: reducing greenhouse-gas emissions by at least 55%, compared to 1990 levels, by 2030.



Common ground sought

The "Fit for 55" package, which is embedded within the European Green Deal and encompasses 14 legislative proposals designed to align current EU laws with the EU's climate ambitions, was presented by the European Commission (**Commission**) in July 2021 for further discussion and agreement with the European Parliament (**Parliament**) and the Council of the European Union (representing EU Member States) (**Council**). Before the proposals can be adopted and signed into regulations, Parliament and the Council must formally agree to the legislative text[1].

While all of the proposals work together to achieve a common goal, three of these proposals are so intertwined (refer to the "principles of operation" section below) that they, in essence, operate as a package deal: the revision and extension of the current EU Emissions Trading System (**ETS**), the introduction of an EU Carbon Border Adjustment Mechanism (**CBAM**) and the establishment of a Social Climate Fund (**SCF**).

On 13 December 2022, the Commission, Council and Parliament reached a provisional political agreement on the introduction of the world's first carbon border adjustment mechanism, while the provisional political agreements on the ETS and SCF were reached on 18 December 2022.

Principles of operation

The EU ETS, which currently applies to limited energy-intensive, high emitting industries[2], is a cap-and-trade system that sets an annual cap on the amount of greenhouse gases that companies in covered sectors may emit. This amount is covered by allowances, which are tradeable. Within the cap, companies either receive emission allowances for free or buy them, and unused allowances can be sold or used the following year. The cap is gradually reduced over time to help ensure emission reductions.

The current ETS, which is the EU's main tool in addressing emissions reductions, only covers companies that operate within the EU, which means that an imported good from the covered ETS sectors into the EU are not supporting any carbon price, while European producers of the same product are supporting a carbon price. Many permits have been allocated free to substantially reduce this risk, while at the same time reducing incentives to decarbonize.

As climate ambition in the EU ETS increases, with higher carbon prices and less free permits, this discriminatory situation could lead to carbon leakage. Carbon leakage is linked to the risk that European producers will delocalize their production to countries where either a lower (or no) carbon price is levied, or consumers will switch from buying EU-produced goods to purchasing substitutes from such non-EU countries. If such carbon leakage occurs, global emissions will not be reduced, or will be reduced by less than the efforts of the EU, thus defeating the efforts of the EU undertaken in reducing its emissions.

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[1] Before most EU legislation can be passed that is binding on Member States, approval by all Member States and the European Parliament is required. (There are exceptions, especially as regards to tax legislation, which require a unanimous agreement of the Council and the Parliament only has a consultative role, but environmental legislation is under the ordinary procedure).

[2] Sectors and gases covered under the current ETS are:
- Carbon dioxide (CO_2) emissions from electricity and heat generation; energy-intensive industry sectors including oil refineries, steel works, and production of iron, aluminium, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids and bulk organic chemicals; and commercial aviation within the European Economic Area.
- Nitrous oxide (N_2O) emissions from the production of nitric, adipic and glyoxylic acids and glyoxal; and
- Perfluorocarbons (PFCs) emissions from the production of aluminium.

The CBAM, which is a supplementary measure to, and mirrors, the EU ETS, operates by imposing a charge on the embedded carbon content of certain imported products that is equal to the charge imposed on the production in Europe of such goods under the ETS (net of free permits), with adjustments being made to this charge to take into account any mandatory carbon prices in the exporting country.

The CBAM will, over time, replace the free ETS allowances currently granted to EU producers assessed to be at high risk of carbon leakage. Therefore, by imposing an equivalent carbon price on the imports of covered goods, the playing field is levelled for both EU producers and producers outside the EU of such goods, as partner countries are encouraged to decarbonise their production processes.

To address the social impacts that arise from the revision and extension of the ETS to other sectors, and to assist those most affected by energy and mobility poverty to cope with the increased costs of the energy transition, support measures under the SCF will be established.

Increased ambition: The finer details

The table below sets out the key elements agreed upon for each of the three proposals. The provisionally agreed-upon text must be formally approved by the Council and Parliament[3].

Regulation	Topic	Provisional agreement[4]
CBAM	Covered products	- The initial scope of CBAM covers imports of goods from **six** emissions-intensive sectors deemed at greater risk of carbon leakage into the EU customs territory based on their Tariff code: o Electricity o Iron and steel, o Cement, o Aluminum, o Fertilizers o Hydrogen. - Certain precursors as well as some downstream products (such as screws and bolts and similar articles of iron or steel) are also included in the CBAM scope. - Before the end of the transitional period, the CBAM will be reviewed to assess whether the scope should be extended to include other goods at risk of carbon leakage, including organic chemicals and polymers, with the intention that all goods covered by the ETS will be included in the CBAM scope by 2030.
	Emissions	- Direct emissions are included - Indirect emissions (e.g., emissions arising from electricity used by manufacturers) will be included under certain conditions.
	Transitional period (linked to the EU ETS)	Phased introduction of CBAM (at the same rate that the free allowances in the ETS will be phased out): - During a three-year transitional phase commencing **1 October 2023**, affected importers will only be required to fulfill reporting obligations. - Thereafter (from 2026), CBAM will be fully operational and CBAM certificates will have to be surrendered (i.e., financial obligations take effect). - CBAM will apply only to the proportion of emissions that does not benefit from free allowances under the EU ETS.

[3] The texts are expected to be formally adopted during plenary sessions at the end of the first quarter of 2023.

[4] Deal reached on new carbon leakage instrument to raise global climate ambition | News | European Parliament (europa.eu); Climate change: Deal on a more ambitious Emissions Trading System (ETS) | News | European Parliament (europa.eu); Deal on establishing the Social Climate Fund to support the energy transition | News | European Parliament (europa.eu); 'Fit for 55': Council and Parliament reach provisional deal on EU emissions trading system and the Social Climate Fund - Consilium (europa.eu)

		- By 2034, CBAM will be fully phased in and no free allowances will be available. - By 2025, the products subject to CBAM will be reviewed to assess whether the scope should be extended to include other goods at risk of carbon leakage, including organic chemicals and polymers, with the intention that all goods covered by the ETS will be included in the CBAM scope by 2030. The review will also include an assessment of the methodology for indirect emissions and the possibility to include more downstream products.
	Exports	- By 2025, the Commission shall assess the risk of carbon leakage for goods produced in the EU intended for export to non-EU countries. If required, a World Trade Organization (**WTO**)-compliant legislative proposal will be presented to address this risk. - An estimated 47.5 million allowances will be used to raise new and additional financing to address any risk of export-related carbon leakage.
	Governance	The governance of CBAM will be centralised, with the Commission in charge of most of the tasks.

Revised EU ETS	Overall emissions reduction ambition in the sectors covered by the EU ETS	An increased ambition of reducing emissions by 62% (currently 40%) in the ETS sector by 2030, compared to 2005 to be achieved though:
		- A reduction in the overall EU-wide quantity of allowances in circulation over two years (“re-basing”):
		    o 90 million allowances in 2024
		    o 27 million allowances in 2026.
		- An increase in annual reduction rate of the cap per year (“linear reduction factor”):
		    o 4.3% per year from 2024 to 2027
		    o 4.4% from 2028 to 2030.

	Removal period of EU ETS free allowances (also linked to CBAM)	Free allowances in the ETS sectors will be phased out over a nine-year period (the largest removal of allowance occurs between 2029 and 2030): - 2026: 2.5% - 2027: 5% - 2028: 10% - 2029: 22.5% - 2030: 48.5% - 2031: 61% - 2032: 73.5% - 2033: 86% - 2034: 100% The CBAM will be phased in at the same rate that the ETS free allowances are phased out.
	Strengthening market stability reserve (**MSR**)	Strengthening the MSR will be achieved by: - Prolonging the increased annual intake rate of allowances (24%) beyond 2023 (i.e., 24% of all ETS allowances will be placed in the MSR to address possible imbalances between the supply of and demand for allowances in the market due to external shocks); and - Setting a threshold of 400 million allowances, above which those placed in the reserve are no longer valid. Excessive price fluctuations will be addressed by providing for an automatic release of allowances from the MSR to the market.
	Inclusion of maritime shipping emissions in EU ETS	The ETS sector coverage is extended to include the maritime sector through a phased-in approach: - Shipping companies will have to surrender allowances that cover:

		○ 40% of their emissions in 2024; ○ 70% of their emissions in 2025; and ○ 100% of their emissions in 2026. - The scope will include offshore vessels above a gross tonnage of 5000. - General cargo vessels and off-shore vessels between 400-5 000 gross tonnage will be included in the monitoring, reporting and verification (**MRV**) regulation from 2025, and their inclusion in EU ETS will be reviewed in 2026. - One hundred percent of all inter-EU voyages and 50% of all international trips to and from EU ports (extra-EU voyages) will be covered under the revised ETS. - The definition of "emissions" will include carbon dioxide (CO_2), methane and nitrous oxide (N_2O).
	Aviation sector	- Free allowance allocations will be phased out by 2026. A gradual phase out will see a decrease of 25% in free allocations for 2024 and 50% for 2025. - As of 2027, flights to third countries not applying a Carbon Offsetting and Reduction Scheme for International Aviation (**CORSIA**) will fall under the scope of the ETS. - A derogation (exemption) will be provided for emissions taking place until 2030 from flights between an airport located in an outermost region of an EU country and an airport located in the same country, and flights between airports located in an outermost region of the same EU country. - Twenty million allowances will be reserved between 1 January 2024 and 31 December 2030 for commercial aircraft operators that increase their use of sustainable aviation fuels (**SAF**), such as hydrogen from renewable energy sources, renewable fuels from non-biological origin and advanced biofuels. - Revenues from auctioning 5 million allowances for aviation will be used through the Innovation Fund to support innovation, new technologies, including electrification in the sector; - The Commission will establish and apply a framework for MRV of non-CO_2 aviation emissions as of 2025. An evaluation will be made in 2027, followed by a legal proposal in 2028, extending the scope of the EU ETS to cover these emissions.
	Incentivisation and funding	- Additional transitional free allocations may be granted, under certain conditions, to the district heating sector in certain Member States to encourage investments into decarbonising that sector. - Installations that will benefit from free allocations will need to comply with conditionality requirements, including in the form of energy audits and, for certain installations, climate neutrality plans. Those who do not comply with these requirements may lose some, or even all, of their free allowances. - The Modernization Fund will support EU countries with GDP per capita below 75% of the EU average. The volume will be increased through the auctioning of an additional 2.5% of allowances of the cap, for which 90% must be used to support priority investments. - Natural gas projects are, in principle, eligible for funding under the Modernisation Fund. However, a transitional measure will allow the current beneficiaries of the fund to continue time-limited financing of natural gas projects under certain conditions.

		- The Innovation Fund will be increased from the current 450 to 575 million allowances, and there will be dedicated calls to decarbonize the maritime sector under the Innovation Fund.
	Municipal waste	Municipal waste incineration may be included in the ETS from 2028, if the Commission concludes, by 31 December 2026, that this is possible following an impact assessment.
New EU ETS (ETS II)	ETS II for buildings, road transport and fuels	- A separate, new ETS ("ETS II") for the buildings and road transport sectors and fuels for certain industrial sectors (such as manufacturing) will be established by 2027. - ETS II will apply to distributors that supply fuels to the buildings, road transport and certain other sectors. - ETS II may be postponed to 2028 to protect citizens if energy prices are exceptionally high. - The emissions reduction trajectory and the linear reduction factor was set at 5.10 from 2024 and 5.38 from 2028. - A new price stability mechanism will be established to ensure that, if the price of an allowance in ETS II exceed €45, 20 million additional allowances will be released to increase the supply in the market. - There will be a temporary possibility for member states to exempt suppliers from surrendering allowances until December 2030, if they are subject to a carbon tax at national level, the level of which is equivalent to, or higher, than the auction price for allowances under ETS II.
SCF	Fund to support vulnerable households, micro-enterprises and transport users to support the implementation of ETS II	- The SCF will commence in 2026 – a year before ETS II commences. - A total of €86.7 billion between 2026 and 2032 will be available to benefit vulnerable households, micro-enterprises and transport users that are particularly affected by energy and transport poverty, - The Fund will finance temporary direct income support measures to tackle the increase in road transport and heating fuel price. - Long-lasting structural investments, including buildings renovation, decarbonisation solutions and integration of renewable energy, purchasing and infrastructure for zero- and low-emission vehicles, as well as the use of public transport and shared mobility services will be covered. - Only measures and investments that respect the principle of 'do no significant harm' and aim to reduce fossil fuel dependency will receive support. - To ensure that Member States commit and contribute to a fair, inclusive transition, 25% of the Fund will be co-financed.

A clear message

When considering what the proposed measures set out above mean for businesses (and individuals), the EU's medium- and long-term goals must be kept in mind – 55% reduction in emissions by 2030, when compared with 1990 levels, reaching climate neutrality by 2050. With this as a backdrop, the EU's decarbonization efforts will continue to intensify and, for the foreseeable future, are here to stay.

The overall effect of these measures is that decarbonization of production will be a key source of competitive advantage for selling into the EU market, whether that production is within the EU or abroad. The measures both increase the returns from decarbonizing, through tighter caps and reduced free permits, while the CBAM ensures these incentives are neutrally applied to imported goods.

In the words of Member of the European Parliament, Pieter Liese, "*More breathing space for citizens and industry in the beginning, but then crunch time for decarbonization*[5]". This "breathing space" is provided in the form of measures such as the initial slow phase-out of free allowances, transitional periods during which only reporting obligations apply, and the implementation of some measures in only three (or four) years' time.
Considerable focus was placed on the funding mechanisms that will support the transition to a low-carbon economy, especially to ensure a fair social transition where "no citizen gets left behind". To further emphasize this point, it was agreed that Member States SHALL spend 100% of the revenue collected from the ETS and CBAM on just transition climate measures.

As pioneer in the decarbonation of society, the EU promotes an open, voluntary and non-exclusive Climate Club to strengthen climate ambition in line with the commitments of the Paris Agreement, to promote relevant measures that have an impact on emission reductions as well as the compatibility of climate measures. While the formation of the first Climate Club was announced on the 13th December 2022 between the G7 countries, only countries with an explicit carbon price and the same climate ambition as the EU (i.e., a carbon price is already being paid on covered goods imported into the EU) will be able to export to the EU without buying / buying a reduced number of CBAM certificates.

Alignment of complimentary regulations

The measures that will be promulgated into regulation to drive a reduction in greenhouse gas emissions under the ETS and CBAM cannot be viewed in isolation. For instance, reducing aviation and maritime emissions require supporting infrastructure at ports and airports; reducing emissions in the road transport sector requires transformational change across the entire value chain.

The Commission has, therefore, proposed complementary Fit for 55 Package mechanisms, some of which have already reached the end stage in the legislative process, requiring only formal approval before becoming binding legislation. The proposed supporting regulations that also apply to the sectors impacted by the revised ETS, ETS II and CBAM include, but are not limited to:

- The FuelEU Maritime Regulation, which aims to stimulate the uptake of low-carbon maritime fuels and renewables and zero-emission technologies to curtail the GHG intensity of energy used by ships at European ports;
- The FuelEU Aviation Regulation, which aims to reduce the environmental footprint of the aviation sector by imposing a SAF blending mandate from 2025 for all flights taking off from an EU airport, regardless of destination
- The proposal for an amendment to Regulation (EU) 2019/631 regarding stricter CO2 emissions standards for new passenger cars and light motor vehicles (vans), which effectively bans the sale of new petrol and diesel cars and vans in the EU market from 2035;
- The Alternative Fuels Infrastructure Regulation (**AFIR**), aims to expedite deployment of a dense, widespread network of alternative fuels infrastructure throughout the EU for refueling and recharging road vehicles, vessels and stationary aircraft;
- The revision of the Energy Performance of Building Directive, which aims to accelerate building renovation rates, reduce greenhouse emissions and energy consumption, and promote the uptake of renewable energy in buildings;
- The revised Renewable Energy Directive[6], which sets increased renewable energy targets for the EU with an emphasis on sectors with relatively slower renewable integration, such as buildings, industry, heating and cooling, and transport;
- The recast of the Energy Efficiency Directive, which requires all EU Member States to use energy more efficiently at all stages of the energy chain and includes new rules for cutting energy consumption by public buildings.

Additionally, to accelerate the green energy transition and in response to the ongoing energy price crisis, the EU published its REPowerEU plan on 22 March 2022[7]. REPowerEU is intended to build on and boost the Fit for 55 package proposals regarding earlier and more ambitious targets for renewable energy and energy efficiency.

The interplay of these Regulations, Directives and plans strengthens the stand-alone objectives of each proposal, working together to ensure that businesses and Member States are pulling in the same direction and consistently working towards the common goal of climate neutrality.

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5 https://twitter.com/peterliese/status/1604280592572497920

6 Renewable Energy and Energy Efficiency Directives - KPMG Global (home.kpmg)

7 Repowering Europe - KPMG Global (home.kpmg)

When considering the impacts that the revised ETS, ETS II and CBAM has, it is, therefore, also necessary to consider the measures that have been put forward under the supporting proposals - particularly as these contain additional measures that businesses will have to adhere to.

Where to from here?

Global climate actions only continue to intensify, and businesses should begin assessing what the legislative changes mean for their operations – whether it be sourcing energy from alternative suppliers; developing storage technologies; analysing existing supply chains, insulating buildings or preparing for energy audits.

As a world-first mechanism, it is important that businesses operating in the CBAM covered sectors, whether located within the EU or trading with the EU, familiarize themselves with and start preparing for the upcoming changes that are less than 10 months away.

To alleviate the cost of transition, it is also valuable to explore the broad range of funding mechanisms that are available either at an EU or Member State level.

Businesses operate in an environment that is no longer "business as usual". We are seeing global trends towards other countries and regions either implementing, or considering the implementation of, legislation that is similar to what exists or is being proposed in the EU. It is, therefore, not only businesses operating in energy-intensive, high-emitting industries that should be putting clearly defined transition strategies in place. As outlined above, the Fit for 55 proposals are interlinked and, taken as a whole, affect most, if not all, sectors of the EU economy, extending to international trade with the EU.

Whether based within the EU or trading with the EU, we encourage companies to consider their own decarbonisation strategies, whether it be to ensure that they are prepared for compliance with upcoming legislation, or to ensure that operations are future-proofed against medium and long-terms global developments.

How KPMG professionals can help

KPMG firms have developed a leading global Climate Change and Decarbonization practice. Working alongside KPMG ESG sustainability and Tax and Legal teams, they can help deliver leading methodologies working collaboratively with clients on the journey to a low carbon future.

KPMG ESG professionals can assist you with a climate risk and decarbonization strategy that includes helping you gain strategic foresight and operational value in your decarbonization journey, from emissions measurement to implementation, monitoring and reporting. All of this is supported by an array of options, such as renewable energy procurement, energy efficiency, circular economy, supply chain management, and includes assessing and understanding the underlying tax and legal impacts.

Through Climate Risk Advisory services, KPMG professionals can help you measure, quantify and assess risks and opportunities across supply chains under a wide range of scenarios and understand the impact on business performance.

They also assist clients with the financing and investment aspects of the low carbon agenda, including fundraising and identifying investment partners and merger and acquisition opportunities, which includes both debt and equity tools.

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