KPMG

Energy Taxation Directive

Introduction

KPMG IMPACT is a platform to support and empower KPMG professionals to assist clients in fulfilling their purpose and helping deliver on the UN Sustainable Development Goals (SDG).

One focus of KPMG IMPACT is on the latest global climate policy developments and their possible impact on international business. To assist with communication of these issues, we have decided to produce a newsletter (on an occasional basis) for those who are interested in the latest climate and decarbonization developments.

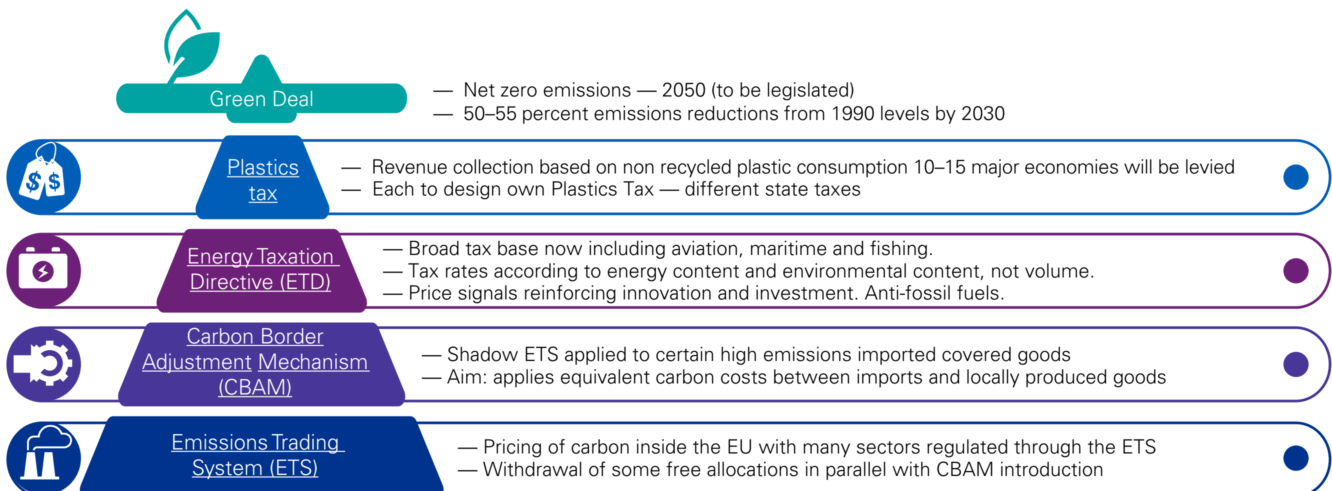
Background

Collectively, the EU Member States are a major contributor to the world's greenhouse gas problem. To address this, on Wednesday 14 July the European Commission (EC) tabled a series of significant carbon reforms as part of its 'Fit for 55 package' to meet its 2030 emission goals. Emissions are already 24% below 1990 levels but the EU is not complacent. Its Fit for 55 package is a broad range of measures, documented across hundreds of pages, that sets out the European Commission's plans for achieving its 2030 target and then progressing to carbon "net zero" (i.e. a position where no more carbon dioxide is emitted than is removed from the atmosphere) by 2050.

The European Commission plans to use a program of interventions — with individual components categorized as "pricing", "targets" or "rules" — that will operate together to achieve its objectives.

The main instrument for reducing emissions will likely continue to be the EU Emissions Trading System (ETS). Revisions to the ETS were also announced in July and it is expected to bring into scope shipping, road and buildings emissions for the first time. This will likely operate alongside the Energy Taxation Directive as it has done since 2005. The ETS is sometimes thought of as a tax but it is, in fact a system for limiting emissions. It does so by making certain sectors pay for emission capacity.

Figure 1: Tax Measures (and other interventions) in the EU Green Deal



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What is the Energy Taxation Directive?

The Energy Taxation Directive (2003/96/EC) — commonly known as the ETD — is the European Union's framework for the taxation of energy products including electricity, motor and most heating fuels. As well as setting out structural rules to avoid potential distortions of competition across the EU, the ETD sets minimum rates of excise duty with the intention of encouraging a low-carbon and energy efficient economy. Member States design their own taxes within the framework of the ETD and can determine domestic rates if they meet the ETD minimum.

Why is the ETD changing?

The ETD took more than a decade to develop and involved lengthy negotiations across the EU. With hindsight, it may seem that the mechanisms introduced by the ETD to encourage a low carbon economy are primitive and insufficient, but it should be remembered that the ETD replaced earlier directives which harmonized only mineral oil prices. In that sense it was part of an evolutionary process towards more focused and efficient environmental taxation. Once it was put in place, however, it was quickly realized that the new directive incentivized behaviors that were not necessarily conducive to reducing carbon emissions.

Criticism of the ETD has grown over the years, with particular emphasis on its failure both to discourage the use of fossil fuels or to encourage intensive consumers of energy to adopt new energy efficient technologies. At present, for example, aviation and shipping remain fully exempt and whilst for other energy uses most Member States do apply tax rates above the minimum set by the ETD, those rates have generally not risen with inflation, thereby eroding their real value and potential to change behavior. Some commentators consider that opportunities may well have been missed to develop new shipping, aviation and other technologies due to the absence of effective incentives.

As long ago as 2008, the European Council asked the European Commission to consider ways to align the ETD with the EU's climate change objectives. The EU considers the ETD to be outdated and has stated that it does not reflect its own climate and energy policies. In particular, there is no correlation between the energy content or environmental impact of individual fuels and the minimum tax rates and scope of the ETD. Many commentators have suggested that, in its present form, the ETD encourages the use of fossil fuels.

What is changing?

The reforms announced in July 2021 include:

- the introduction of tax rates — expressed in euros per gigajoule — based on the energy content and environmental impact of energy products rather than on volume (as is generally the case now); and
- a widening of the tax base to include energy contents and processes that were previously not in scope;
- the recognition of new energy products such as hydrogen;
- measures to prevent the double taxation of stored electricity;
- a significant reduction in the ability for Member States to exempt or reduce the rate applicable to energy products, processes and sectors;
- an increase in the minimum rates of tax to reflect current pricing, and annual adjustments to those minimum rates based on the Eurostat price index; and
- a five-yearly review safety net to keep the ETD up to date.

The intention is for the revised ETD to rank fuels and electricity according to energy content and environmental performance and for Member States to tax them accordingly, helping to ensure that the most polluting energy products bear the greatest amount of tax. These changes, although conceptually simple, represent a radical reworking of the ETD that is likely to have a real impact on fossil fuel consumption over the medium to long term. Individual Member States can have an opportunity to consider the minimum rates that they plan to adopt, of course, but the European Commission considers that there will likely be a convergence — if not a standardization — of rates over time.

Widening the tax base

The widening of the tax base will likely bring both kerosene (used by the aviation industry) and maritime industry heavy oil into scope for intra-EU voyages, removing the previously exempt status of these fuels. The European Commission describes this as a "crucial measure given the role of these sectors in energy consumption and pollution". The minimum rates for kerosene and heavy oil are expected to increase over a ten year period to allow the industry to adapt. The use of sustainable fuels in shipping/fishing and aviation should be incentivized by a minimum rate of zero — which is likely not to be substantially, if at all exceeded, by most Member States in the short term.

How will social fairness be protected?

Whilst businesses are expected to face some significant changes as the ETD is adopted and domestic taxation evolves, the EU is promoting the Just Transition Fund, the Social Climate Fund and the European Social Fund to help protect vulnerable households as fossil fuel prices rise. The revised ETD is not expected to prescribe how member states should design their tax systems or use the revenues raised. The EC merely:

- encourages the design of environmental taxes that promote employment, social fairness and growth; and
- through the ETD, permits member states to exempt some households from electricity and heating fuel taxes.

History shows that well-designed environmental taxes can promote economic growth, employment and social fairness so good tax design will likely be essential.

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Proposed minimum tax rates		
Fuel types	**Example fuels**	**Minimum Tax Rate**
Conventional fossil fuels and non-sustainable biofuels	Gas oil, petroleum	10.75 euros/GGJ
Fossil-based fuels supportive of decarbonization in the short term	Natural gas, liquefied petroleum gas (LPG)	For the first 10 years 7.17 euros/GGJ for motor fuel and 0.6 euros/GGJ for heating
Sustainable but not advanced biofuels*	Food crop derived biofuels Wood mass derived biofuels	5.38 euros/GGJ for motor fuel and 0.45 euros/GGJ for heating
Electricity, advanced sustainable biofuels, biogas and renewable non-biological fuels	Renewable hydrogen	0.15 euros/GGJ

Source: KPMG 2021

* The EU should define the term "sustainable but not advanced" biofuels

When will the revised ETD come into force?

As the new ETD is a revision of an existing directive, its unanimous acceptance by all members of the EU Council is required. Any dissenters are likely to be called upon to suggest other solutions for reaching emissions reduction targets. Provided unanimity is achieved, the ETD should come into force in January 2023. Once adopted, Member States are expected to implement changes to their domestic legislation.

KPMG Impact

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KPMG IMPACT includes a *Virtual Center of Excellence (VCOE) for Excise and Environmental Taxes*, comprising more than 140 excise and environmental specialists globally.

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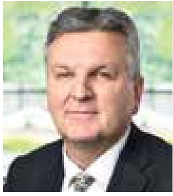

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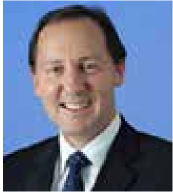

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