The road to a road ETS

How to design a socially fair and environmentally effective system

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Summary

Over the last two years, there has been plenty of debate about the added value of implementing a new Emissions Trading System for road transport and buildings (ETS2). T&E had two main concerns with such a system. First, that it could put at risk the existence of national climate targets through the Effort Sharing Regulation. Second, that it could imply the end of CO2 standards for road vehicles, the most impactful measure to reduce emissions in the transport sector so far. As part of the Fit For 55 package, both policy tools remained in place and were strengthened. Therefore, our fears didn't materialise.

While such a new ETS will not be the main tool to decarbonise road transport, it can play an important role to on the one hand tackle demand but most importantly also to generate new revenues for supporting the most vulnerable in their transition away from fossil fuels. For these benefits to materialise, both the ETS2 and the newly proposed Social Climate Fund (SCF) need to adhere to a number of criteria ensuring the new system is both socially fair and environmentally sound. This T&E briefing presents a list of 10 such criteria so policy-makers can incorporate them into both the ETS2 and SCF proposal during the co-decision process.

What criteria should be taken on board when improving the ETS2 and SCF proposals?

A. EU climate architecture demands

1. Regulatory measures must be at the heart of the emissions U-turn for transport and buildings

- Increase ambition in EU sectoral regulations (car, van & truck CO2 standards, Energy Performance of Buildings Directive, Renovation Wave) - It's big companies, rather than citizens, who have the resources, skills and scale to drive the transition. Therefore the bulk of the responsibility for delivering on our climate targets should lie in their camp. Car CO2 standards are a great example of this. They have ensured carmakers ramped up electric cars, thereby bringing upfront purchasing cost price parity within reach.

- Eliminate loopholes and improve compliance under the ESR - Climate action in the transport and buildings sectors cannot be left to markets alone. Member states must remain active contributors to the EU's climate ambition. Ambitious national climate targets keep the incentive high to eliminate non-market barriers at national level, as long as there are not too many loopholes in the system (which inflate the emissions budget) and compliance is ensured.[1]

- Move away from the current approach of policy measures aiming at alleviating energy poverty towards an obligation for Member States to eradicate within the current decade energy and mobility poverty.

2. A stepwise implementation of the polluter pays principle is needed

- Internalize all external costs - To reduce demand for fossil fuels and private cars sufficiently and fast enough, we will need carbon pricing on top of those more stringent regulatory measures. Reflecting the cost of pollution in the price of fossil fuels will help to create a level-playing field with the renewable electricity-based alternatives we want to promote.

- Remove all environmentally harmful subsidies through a combination of pricing (e.g. making fossil fuels more expensive than heat pumps), climate friendly financial support (e.g. using EU finance only for the renovation of buildings to nearly zero-energy standard) and regulatory measures (e.g. ending subsidies for polluting company cars).

3. The social impacts of the Ff55 package go beyond the ETS2 and need an EU-level answer

- A SCF is highly needed - While the Just Transition Mechanism already provides support to people in certain regions dependent on fossil fuels to adapt to the clean energy transition, a mechanism that directly supports the lowest incomes in the transition was thus far missing and is also highly needed.

[1] See our ESR briefing for more information on how the ESR should be improved: https://www.transportenvironment.org/wp-content/uploads/2021/12/TE-ESR-briefing-dec-2021-final.pdf

- The SCF cannot solve all pre-existing social issues - Already today, energy and mobility poverty across the EU-27 is a big problem. While some climate measures contribute to that problem, the root causes lie beyond our climate policies (e.g. low wages, lack of social safety net, lack of social housing and public transport, etc.). The SCF cannot be expected to solve all of these root causes, nor can it solve the more general distrust of some parts of society in their governments.

- From repair to prepare - Existing EU climate policies and other elements of the Ff55 package also have social impacts. The EU should play a role in ensuring these are adequately addressed. The scope of the SCF therefore needs to shift from repairing and compensating for the ETS2 impact alone towards ensuring that all households, including the less wealthy ones, can actively participate in the transition. At the same time, those who can afford it should pay for the cost of the transition themselves.

- Inter-EU solidarity - Different countries will be differently affected by the necessary transition in the transport and heating sectors. European solidarity is needed to ensure all governments can implement the needed measures at national level in a just way and at an increasingly similar pace.

A. ETS2 design side demands

4. Climate efforts should be divided fairly between societal actors and sectors

- No more free allowances for industry - We cannot ask citizens to pay for all their emissions while big industrial polluters still receive emission permits for free under the existing ETS (the ETS1 for stationary installation and aviation). As the ETS2 is negotiated together with the ETS1, a fair distribution of efforts respecting the polluter pays principle should be ensured across the package.

- Oil companies should absorb part of the ETS2 cost - As important as scaling up the carbon price signal is to reduce demand, citizens (and especially low-incomes who are usually locked into polluting technologies) are not the only polluters and certainly not the biggest ones. While being well aware of the consequences of climate change, causing environmental disasters at large scale and paying almost no taxes, Big Oil made nearly 2 trillion in profits (that's a 13-digit number) in the last 30 years. It's high time for Big Oil to pay back to society. They should be required to absorb part of the EU's new carbon price, while we use the price to break free from our energy dependence on profit hungry multinationals and oligarchs.

- No ETS2 money for the Innovation Fund - The majority of the ETS2 revenues come from citizens. Therefore from an equity and public acceptability point of view, the money should also flow back to citizens and not to the industry. As the Innovation Fund does not earmark funds per sector, this money will likely not even end up with companies active in the road transport and buildings sectors, but support projects for green steel etc. Innovative projects in the road transport and buildings sector should have a clear social angle so they become eligible under the SCF.

5. Fossil fuel prices must increases, but step-by-step and without shocks

- Increased EU regulatory ambition needed to prevent high prices - More ambition in car, van and truck CO2 standard[2], the EPBD and the ESR (national policies) equals lower ETS2 prices, as they reduce the emissions gap with the EU's 2030 target. This is very important to prevent the ETS2 price from rising too high already before 2030.

- Shock prevention through a better MSR and excessive price increase mechanism - The proposed MSR design creates shocks in the system and should be designed to operate more smoothly. The excessive price mechanism on the other hand should be relaxed to ensure it reacts to price spikes more often and more quickly.

- A counterbalancing mechanism for big oil and gas price fluctuations - While we want fossil fuels to become more expensive, we are looking for a gradual price increase (through CO2 pricing) and not for sudden price hikes (like the current oil and gas crisis) that come with considerable social impacts. Under the current ETS1 and ETS2 design, the price effect of exploding oil and gas prices is amplified by rising carbon prices on top of that. That double effect should be tempered by introducing a safeguard: if the oil/gas prices rises above a predefined level, the ETS2 allowance market is loosened. Not to the extent that it fully offsets the impact of the increasing oil and gas prices, but to ensure it doesn't add a price on top of that as social compensation measures would have a hard time following that speed. Similarly, if oil and gas prices decrease below a predefined level, the carbon market would be tightened so people don't feel that entire price reduction at the fuel pump because the carbon price levels out the effect.

B. ETS2 revenues demands

6. Revenues must flow back to the citizens

- Direct financial compensation needed - The SCF can drive large-scale (social) housing renovations, improve public transport and pre-finance or subsidize electric (including shared) alternatives for the lowest-incomes. But this will take time (possibly only with a positive effect on project beneficiaries' energy bill after 2030) and only alleviate the burden of the ETS2 price for a limited number of those who need it (as project money will be limited and only available in

[2] See our car CO2 standards briefing for more information on how this proposal should be improved: https://www.transportenvironment.org/wp-content/uploads/2021/11/2021_11_Car_CO2_position_paper.pdf

yearly slices). Therefore, the revenues that don't go to the SCF but go directly to the member states should flow back to citizens. To ensure no one is driven (further) into poverty because of the ETS2 price, this direct financial compensation already needs to start before the ETS2 price kicks in. This can be done by frontloading the expected revenues by 1 year.

- The more visible, the better - Financial compensations can consist of lump-sum 'climate dividend' payments to all citizens, targeted support for the lowest incomes or a reduction of electricity taxes and levies. The more visible the compensation, the greater the chance for a 'double dividend' in the form of increased support for climate measures.

- EU communication and steering essential - Member states can be tempted to blame the EU for the increased fuel prices while taking the credit for the financial compensations. To avoid backlash against the EU, the EU should communicate actively on the social obligations put in place for the member states aimed at ensuring that the rich and not the poor pay for the cost of transition. The Commission should also communicate on how member states are doing with the implementation of those obligations. Through its communication, the EU should highlight the benefits of EU climate, pricing and social policies such as improved air quality, better living conditions and health, energy independence, etc. Projects developed under the SCF should have clear signs indicating they are paid for through an EU Fund, as is the case for the ERDF and Cohesion Fund.

C. Additional Social Climate Fund demands

7. The SCF should be scalable

- A lever for additional national funding - The Social Climate Plans should not remain limited to a description of the measures that will be financed through this EU fund, but should instead entail the member states' entire plan to ensure a 'guarantee to switch' for the lowest incomes deciles over the coming decades. This should include additional national programs that will be developed through additional financing from the general budget or other revenue streams, as well as their expected impact on emissions and household expenditure. That would allow for the Fund's impact to go beyond just compensating for the social effects of the new ETS. It would make the Social Climate Plans a lever for additional national funding to become available to the lowest incomes and for a true debate at national level on how the government is planning for a just transition.

- Adequately resourced - The SCF should provide enough support to member states, on an equitable basis, to enable the right investments in tackling energy and mobility poverty and to deliver the urgent climate action needed. As the existing ETS1 already has a distributional impact on poorer households, the ETS1 should cofinance the SCF. ETS1 revenues alone however will not be able to replace the entire funding amount that is currently foreseen through the ETS2. Therefore, a sufficiently resourced SCF is impossible without an ETS2.

- Funding linked to the ETS2 price - Currently the SCF has a fixed budget that is decoupled from the ETS2 price. While there should be a floor budget in the Fund that is fixed regardless of the ETS2 price, the amount of money made available for projects should increase when the ETS2 price increases

8. The SCF must be sustainable

- The fund must exclude any kind of investments into fossil fuels or technologies that lock-in emissions (e.g. gas boilers) and instead emphasise climate positive investment measures.

9. The SCF must include clearer definitions and eligibility criteria

- Mobility poverty - While 'Fit for 55' proposes a definition of energy poverty in the revised EED, there is currently no EU definition of what mobility poverty means. The SCF should include the following definition: ''*Mobility poverty means a household is unable to afford the necessary travels required to meet essential socio-economic needs in a given context and can be caused by one or the combination of the following factors, depending on national and local specificities: low income, high fuel expenditures and/or high costs of public transport, availability of other mobility alternatives and their accessibility and location, travelled distances, transport practices and the poor performance of vehicles".*

- Additionality - Safeguards are needed to ensure the revenue spending is additional and does not replace existing national climate action or social welfare spending. However, the projects developed under the SCF and the financial support should be allowed to benefit those households who already receive support today (e.g. through social energy tariffs). While the current SCF proposal does not allow for this, these are the households who will be most in need of support when energy prices increase. Some existing social schemes might therefore require topping up through the ETS2 revenues.

10. The SCF must be timely, inclusive and transparent

- Timely **-** It is essential that the SCF already comes into force before the ETS2 does. A synchronised process with the NECPs is necessary to ensure a holistic approach of the NECPs as well as to ensure the social measures envisaged under the Social Climate Plans have a clear climate benefit. But that doesn't mean that the process cannot be speeded up. Projects that are in countries' draft NECPs and that meet all of the criteria for approval should already be approved and funded before the NECPs are fully finalised, meaning from 2023 onwards. This speeds up the Commission's timeline by 2 years.

- Inclusive - All stakeholders should be involved in the drafting and implementation process of the Climate Social Plans, with special attention to meaningful participation from those groups for whom the projects and financial support is actually intended. The process should also involve local governments and communities, as these often have a better view of the local needs. The Commission should provide guidance and best practice examples across the EU.
- Transparent - Spending of the money retrieved from the Social Climate Fund and progress on the Social Climate Plans should be transparent and accessible to the public. Monitoring mechanisms must ensure the quality of spending, the delivery of the promised impacts and the mitigation of the carbon costs. Regular qualitative and quantitative analysis of the benefits of the ETS2 and SCF must inform reviews and adjustments to the system.

Further information

Sofie Defour
Climate Manager
Transport & Environment
sofie.defour@transportenvironment.org
Mobile: +32(0) 479 57 28 93