

EXTENSION AND REFORM OF THE EU EMISSIONS TRADING SYSTEM

On 16 May 2023, legislation extending and reforming the EU Emissions Trading System was adopted. The revisions bring shipping into the EU ETS for the first time, establish a parallel emissions trading system for buildings and transport, and make a wide range of other changes to the EU ETS aimed at implementing the EU's 'Fit for 55' initiative. This briefing looks at the key changes.

CONTEXT OF THE REVISIONS TO THE EU ETS

EU Emissions Trading System (EU ETS) reform is part of a broader set of carbon reduction reforms being implemented by the EU under the "Fit for 55" initiative. This initiative, adopted by the European Commission in July 2021, contains proposals to achieve the EU Green Deal's target of reducing greenhouse gas emissions by at least 55% by 2030, and achieving "net zero" emissions by 2050, is in line with the Paris Agreement objective to keep the global temperature increase to well below 2°C and pursue efforts to keep it to 1.5°C.

Other reforms adopted in the same package of legislation include establishment of a Carbon Border Adjustment Mechanism (CBAM), to prevent so-called 'carbon leakage' (see our separate [briefing](#) on the CBAM), and regulations for the future establishment of a Social Climate Fund, to support those affected by 'energy poverty' in the energy transition.

The EU ETS reforms support the reduction of greenhouse gas (GHG) emissions by making changes such as decreasing the GHG emissions cap to reduce how many allowances are put on the market each year. The changes have been implemented through a number of instruments that revise the EU ETS Directive (2003/87/EC), the Monitoring, Reporting and Verification Regulation (EU) 2015/757, and the Market Stability Reserve Decision (EU) 2015/1814 (the Amending Legislation).

INCLUSION OF SHIPPING

As from 1 January 2024, the EU ETS will be extended to include maritime emissions from commercial passenger or cargo ships of 5000 gross tonnage or more. Offshore ships of 5000 tonnage or more will then enter the EU ETS as from 1 January 2027.

Coverage and phased implementation

100% of emissions for all intra-EEA voyages (including any emissions from ships within an EEA port) will be covered by the EU ETS, and 50% of emissions for journeys from EEA ports to non-EEA ports and vice versa. The

Key issues

- Maritime Shipping of 5000 gross tonnage or more will be included in the EU ETS from 1 January 2027
- Aviation emissions: CORSIA will be implemented into EU law for the period up to the end of 2026, and the Commission will review whether CORSIA is sufficiently strong and broad-reaching to avoid the need to bring CORSIA emissions into the EU ETS after that time
- Total allowance numbers in the EU ETS will be reduced (while reflecting inclusion of maritime emissions)
- Free allocation of allowances will also be reduced and gradually phased out, in particular to co-ordinate with the establishment of the Carbon Border Adjustment Mechanism
- A new standalone emissions trading system at the level of fuel suppliers will apply to the buildings, transport sectors, and some other targeted industrial sectors

obligation to acquire and surrender allowances will be phased in over time and will cover:

- 40% of verified emissions reported in 2024;
- 70% of verified emissions reported in 2025; and
- 100% of verified emissions reported in 2026 and for subsequent years.

Initially, only carbon dioxide (CO₂) will be covered by the amendments, but from 1 January 2026, this will extend to methane and nitrous oxide.

Enforcement and Derogations

The Amending Legislation enables Member States to refuse entry to shipping company ships to EEA ports for failure to surrender sufficient allowances over two or more successive enforcement periods, replicating powers already contained into the shipping Monitoring, Reporting and Verification (MRV) Regulation (Regulation EU/2015/757).

Various derogations also apply until 31 December 2030 in relation to ice-class ships, and certain voyages between islands and their mainlands, between remote regions and other ports in the same jurisdiction, and between Member States not having a land border between them.

Administration

The administering state for EU ETS purposes for each shipping company will be the Member State where it is registered, or if not registered in a Member State, the Member State where most port calls occur during the preceding four year monitoring period, or if none, the first Member State port of call. Practically, this means that subsidiaries within the same corporate group (if they are caught as shipping companies) could be allocated to different administering states, causing additional complexities in setting up compliance structures and processes (noting also that the Amending Legislation does not allow for shipping companies to register and comply collectively at group level).

Monitoring, Reporting and Verification

The shipping MRV Regulation has required CO₂ emissions reporting in relation to ships above 5000 gross tonnage since 2015. Changes to that Regulation will mean that MRV obligations will be extended from 1 January 2025 to general cargo ships, and offshore ships, of at least 400 gross tonnage. From 1 January 2024, the obligations will extend beyond CO₂ to methane and nitrous oxide emissions. A monitoring plan for all existing and new requirements will need to be submitted to the administering authority in respect of all ships covered by the Regulation by 1 April 2024 (whether or not they had previously been covered by a monitoring plan). From 2025, new requirements will also be imposed on shipping companies to provide company-wide aggregated emissions data to the administering authority.

Further changes

Discussions are ongoing at the International Maritime Organisation (IMO) around the potential for a global market measure to reduce Carbon (analogous to CORSIA for aviation). The Commission will keep progress under review and revisit the shipping provisions of the EU ETS as appropriate. However, where such a measure has not been put in place, the Commission will consider extending the coverage of international voyages beyond the 50% level described above.

AVIATION: IMPLEMENTATION OF CORSIA AND OTHER CHANGES

Implementation of CORSIA

Intra-EEA flights have been covered by the EU ETS since 2012, but flights between the EEA and the rest of the world are currently excluded from the EU ETS until 31 December 2023. While intra EEA flights will remain in the EU ETS as before, the Amending Legislation implements CORSIA into EU law on the basis that it will apply to flights to and from third countries participating in CORSIA during the calendar years running from 2021 to 2026, and the exclusion of such flights from the EU ETS will therefore be extended up to the end of 2026.

The Commission will undertake a review of CORSIA and its effectiveness by 1 July 2026. If the Commission decides that, by that time, the ICAO has not strengthened CORSIA sufficiently into a Paris agreement-aligned trajectory, or CORSIA covers less than 70% of international aviation emissions, then the Commission will propose legislation to bring international flights from the EEA to third countries into the EU ETS as from 2027, and aircraft operators would, in such a case, be able to credit their CORSIA costs against the costs of EU ETS compliance. The EU ETS will apply to flights to and from a third country that does not participate in CORSIA as from 2027, tying in with the date when CORSIA compliance by signatory party aircraft operators becomes mandatory.

Where the Commission finds that non-EEA States are failing to fully apply CORSIA resulting in significant distortion of competition, the Commission reserves the power to waive the requirement for operators to comply with their CORSIA offsetting obligations under the Directive.

Other key reforms

Other key reforms in the Amending Legislation include a gradual phasing out of free emissions allowances for the aviation sector in 2024 and 2025, with full auctioning of allowances being implemented from 2026. From 1 January 2026, the entire quantity of allowances in respect of which free allocation would have taken place in that year shall be auctioned, except for those specified below.

Supporting the transition to sustainable aviation fuels, from 1 January 2024 until 31 December 2030 a maximum of 20 million of the total quantity of allowances will be allocated to cover part of the price differential between existing fuels and sustainable aviation fuels. These allowances are meant to cover:

- 70% of the remaining price differential between the use of fossil kerosene and hydrogen from renewable energy sources, and advanced biofuels;
- 95% of the remaining differential between fossil kerosene and renewable fuels of non-biological original; and
- 50% of the remaining price differential between fossil kerosene and any other eligible non-fossil fuel-derived aviation fuel (100% for fuels supplied at some small island airports).

These allowances will be allocated annually to commercial aircraft operators on a transparent, equal treatment and non-discriminatory basis.

A MRV framework for non-CO2 aviation effects will also be set up by the Commission to increase transparency with regard to all emissions from aircraft operators from 1 January 2025. Non-CO2 effects are specified as being the climate-related effects from the release of nitrogen oxides, soot particles, sulphur oxides, and water vapour as a result of aviation fuel combustion. By the end of 2027, the Commission must consider whether it is appropriate to extend the EU ETS to non-CO2 emissions.

CHANGES TO THE MAIN EU ETS LEGISLATION

The Amending Legislation makes a number of key changes to the EU ETS including:

- **Number of Allowances:** reductions in the total union-wide quantity of allowances available in 2024 (by 90 million allowances) and 2026 (by a further 27 million allowances) to better reflect actual emissions. The linear reduction factor is also being increased from 2.2% to 4.3% from 2024-2027 and then to 4.4% from 2028, whilst factoring in the inclusion of emissions from shipping.
- **Benchmark reform:** among other changes to free allocation of allowances, the benchmark system of calculating free allocation for certain products and industries will be tightened further for the period from 2026 to 2030. Benchmark values, to be set by the Commission, will be subject to a minimum increase of 0.3% each year (up from 0.2%) and a maximum of 2.5% per year (up from 1.6%). Notably, the steel industry will be excluded from this change to reflect and further encourage technological progress in the industry.
- **Reduction / phasing out of free allocation of allowances:** for example, installations covered by the obligation to conduct an energy audit or to implement a certified energy management system under Article 8 of Directive 2012/27/EU of the European Parliament and of the Council will, in principle, face a reduction of free allowances received by 20% if either the audit is not carried out, or they are among the 20% highest emitters in the sector and they have not established a climate neutrality plan for all relevant installations.
- **Interaction with the CBAM:** for sectors that produce goods covered by the CBAM, the reduction of free allocation will be implemented by a gradual reduction while CBAM is phased in from 2026 to zero free allocation in 2034 and onwards (see our separate [briefing](#) on the CBAM), in effect creating a level playing field in those sectors between EU and non-EU producers.
- **Changes to deadlines for the grant and surrender of allowances:** In response to changes made over the years to the process for issuing free allowances which have added to the administrative burden on operators, the annual deadline for grant of allowances under free allocation has been moved back from 28 February to 30 June. Consequently, the annual deadline date for surrender of allowances has also been moved back from 30 April to 30 September.
- **Modernisation Fund:** Increased funding from auctioning allowances will be directed to the Modernisation Fund which supports scale investment projects to modernise energy systems and improve energy efficiency. The scope of both the Modernisation Fund and the

Innovation Fund will be broadened. Significantly, any funds provided to the Innovation Fund from 1 January 2025 will need to comply with the "Do No Significant Harm" (DNSH) principle under the EU Taxonomy Regulation for investments in activities covered by Technical Screening Criteria under that Regulation.

ETS2: BUILDINGS, TRANSPORT AND MISCELLANEOUS

Introduction of ETS2

In parallel to the amendments to the EU ETS, the Commission has proposed a separate emissions trading system, "ETS2", to cover combustion-related emissions from activities not otherwise covered by the EU ETS, being commercial and residential buildings (including supplies from district heat networks), road transport, and some additional targeted sectors comprising fuel combustion from energy industries, manufacturing and construction.

Structure and compliance requirements

ETS2 will be established as a separate self-standing system from 2025. It will broadly follow the same cap-and-trade mechanism as the existing EU ETS, including having an annual calendar year compliance period.

Organisations that fall under ETS2 will be required to:

- obtain a GHG emissions permit by 1 January 2025;
- report emissions from 1 January 2025 (for calendar years 2024 and 2025); and
- buy allowances at auction for the first time in 2027, and surrender allowances by 31 May each year, beginning in 2028, although these deadlines may be pushed back by a year if energy prices are deemed exceptionally high.

Notably, under ETS2 there will be no free allocation of allowances; all allowances will be auctioned. ETS2 provides for an annual linear reduction trajectory for emissions to meet the 2030 reduction targets of 42% reduction in emissions compared to 2005 levels.

Member States will be allowed to temporarily exempt a regulated entity from surrendering allowances under ETS2 until 31 December 2030 to the extent that it pays a national carbon tax in respect of its emissions which is higher than its ETS2 liability would be.

Regulated entities will be subject to MRV obligations in relation to their emissions and a separate market stability reserve will also be established.

Interaction with the German national emissions trading system

ETS2 will cause particular complexity in Germany given the existing German national emissions trading system under the Fuel Emissions Trading Act (*Brennstoffemissionshandelsgesetz*, "BEHG"). The German system is similar to ETS2 and was introduced in 2019 before the "Fit for 55" initiative began. The current German Federal Government stated in its coalition agreement that it will review the compatibility of the BEHG with ETS2 and will most likely adjust the BEHG to enable a smooth transition between both systems. It will be interesting to see how the German legislator will transpose ETS2 into national law and what adjustments may be necessary. We will closely monitor the latest developments in this respect.

FINAL COMMENTS

The combined effect of these changes is to significantly expand the scope and ambition of the world's second largest compliance carbon market. Existing EU ETS dutyholders will face increased production/operating costs related to both the reduction of free allocation and increased exposure to carbon prices in the secondary market for EU allowances; and a range of operators in the shipping sector and ETS2 sectors will find themselves newly caught and subject to the gamut of complex compliance ETS obligations and the vicissitudes of carbon market price hedging.

That new reality is already being felt in the maritime sector, where shipping operators and NGOs like BIMCO have for some time been developing contractual approaches towards allocating the cost and responsibility of EU ETS compliance between shipowners, charterers, and operators.

That said, the purpose of cap and trade schemes like the EU ETS is to incentivise the transition to a low carbon economy by rewarding those that can cut their emissions at a rate which outpaces their competitors and the market as a whole. In that sense, it will be seen by some as an opportunity to gain a competitive edge through accelerated decarbonisation in their production processes and value chain.

The implementation of the CBAM in parallel with the ratcheting up of the EU ETS should also mitigate the risk of carbon leakage from the EU to some degree, although that is an ever-present risk in the face of increased regulation of emissions by the EU.

Should you need advice regarding how the EU ETS revisions could affect your organisation, please contact our specialist team.

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