EUROPEAN COMMISSION PROPOSES TO ADAPT ITS LEGISLATIVE FRAMEWORK IN VARIOUS POLICY AREAS TO MAKE IT 'FIT FOR 55'

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By: Giovanni Campi, Sofia Karagianni

INTRODUCTION

On 14 July 2021, the European Commission (Commission) released its mega 'Fit for 55' policy Package (Package) to reduce emissions by at least 55 percent by 2030 in order to achieve a carbon-neutral Europe.

In the Package, the Commission lays out the blueprints on how to achieve this ambitious objective by amending existing legislation and proposing new legislative initiatives in the areas of climate, energy, land use, transport and taxation.

With the Package, the Commission is presenting the legislative tools to deliver on the targets agreed in the European Climate Law and thus fundamentally transform the European economy and society.

The various proposals included in the Package will now be scrutinised by the EU co-legislators (Council of the EU and European Parliament), who will need to agree on the final legislative texts before their entry into force and application. The political sensitivity of some of the initiatives suggests that the legislative process of some proposals will be longer than others.

THE PACKAGE

The Package covers various policy areas and pieces of legislation, including:

The Revision of the EU Emission Trading System (EU ETS)

The EU ETS is a scheme that caps and prices emissions from certain industries.

The refreshed proposal provides the expansion of the EU ETS to sectors not yet covered by it such as maritime shipping, and imposes more stringent requirements on aviation. On shipping, the proposal indicates that shipping companies will have to purchase and surrender EU ETS emission allowances for each tonne of reported CO_2 emissions. Importantly, it mentions that shipping companies will only have to surrender allowances for a portion of their emissions during an initial phase-in period, reaching 100 percent after three years. On aviation, the Commission proposes to gradually remove free emissions allowances and to move to full auctioning of allowances by 2027 in order to reduce emissions.

Furthermore, the proposal recommends the development of a separate, adjacent EU-wide emissions trading system, which will put a price on emissions from the building and road transport sectors. This separate system will regulate fuel suppliers, rather than individual households and car drivers. Fuel suppliers will be responsible for monitoring and reporting the quantity of fuels they place on the market and for surrendering emission allowances each calendar year depending on the carbon intensity of the fuels. The new system is designed to start operating from 2026.

The Development of a Climate Social Fund to Ensure That the Green Transition is 'Just' and no one is Left Behind

In essence, the Climate Social Fund will aim to compensate EU citizens for any possible adverse effects, as a result of the expansion of carbon pricing to transport and buildings' heating systems. It will be financed by the EU budget, using an amount equivalent to 25 percent of the expected revenues of emissions trading for building and road transport fuels.

Revision of the Regulation on the Inclusion of Greenhouse Gas Emissions and Removals From Land Use, Land Use Change and Forestry (LULUCF)

The LULUCF sets a binding commitment for each Member State to ensure that accounted emissions from land use are entirely compensated by an equivalent accounted removal of CO2 from the atmosphere through action in the sector.

The revised proposal puts in place binding targets for Member States to increase their net carbon removals in the land use and forestry sector for the period from 2026 to 2030. It is also proposing to aim for an EU-level objective to reach climate neutrality in the combined land use, forestry and agriculture sector by 2035, including non-CO2 agricultural emissions, such as those from fertiliser use and livestock.

Revision of the Effort Sharing Regulation (ESR)

The ESR establishes binding annual greenhouse gas emission targets for Member States, addressing emissions from most sectors not included in the EU ETS, such as transport, buildings, agriculture and waste. The reviewed proposal looks at different options in light of an expansion of emissions trading and potential changes and ongoing reviews of other related pieces of legislation, e.g., on energy efficiency in buildings and mobility. In this regard, it suggests the reduction of emissions under the ESR by at least 40 percent, compared to 2005 levels. As regards the extension of the EU ETS to sectors such as buildings and road transport, which are also covered by the ESR, the proposal notes that keeping them under the ESR scope as well is important, as it would be premature to leave the aimed decrease in emissions from buildings and road transport exclusively to emission trading.

Revision of the Renewable Energy Directive

The original Renewable Energy Directive established a common framework for the promotion of the generation of energy from renewable sources in the EU and set a binding target of 32 percent for the overall share of energy from renewable sources in the EU's gross final consumption of energy in 2030.

The revised proposal issued today increases the target to 40 percent of energy from renewable sources by 2030. Importantly, among other renewable energy sources, it also promotes the use of green hydrogen, or electrolytic hydrogen produced from renewable energy sources, by extending the EU-wide certification system for renewable fuels to include hydrogen.

Moreover, the reviewed proposal places more stringent sustainability criteria for the use of bioenergy, while holding that Member States must design any support schemes for bioenergy in a way that respects the cascading principle of uses for woody biomass. This means that biomass for energy must be produced, processed and used in a sustainable and efficient way in order to optimise greenhouse gas savings and maintain ecosystem services, all without causing deforestation or degradation of habitats or loss of biodiversity.

Revision of the Energy Efficiency Directive (EED)

The original EED promotes energy efficiency across the EU, by removing barriers and overcoming market failures that impede efficiency in energy supply and use in different sectors. The revised proposal sets a more ambitious binding annual target for reducing energy use at the EU level, while requiring the public sector to renovate three percent of its buildings each year to drive the renovation wave and create more jobs.

Revision of the Energy Taxation Directive (ETD)

The ETD lays down the EU rules for the taxation of energy products used as motor fuel or heating fuel and for the generation of electricity. The main objective of the review is to end tax exemptions for non-environmentally friendly fuels, which will incentivize companies that use such fuels to switch to more sustainable fuel sources in order to avoid increased tax burdens.

In this context, the recast proposal introduces a new structure of tax rates based on the energy content and environmental performance of the fuels and the generated electricity. Moreover, it broadens the taxable base by including more products in the scope and by eliminating some of the current exemptions and reductions. In this regard, it stipulates that kerosene used as fuel in the aviation industry and heavy oil used in the maritime industry will no longer be fully exempt from energy taxation for intra-EU voyages.

The Presentation of the FuelEU Maritime Initiative

The FuelEU Maritime Initiative focuses on ramping up the production, deployment and uptake of sustainable alternative marine fuels. In the same vein, the Commission also presented the ReFuelEU Aviation Initiative, which would task fuel suppliers to blend increasing levels of sustainable aviation fuels in jet fuel taken on-board at EU airports.

Revision of the Alternative Fuels Infrastructure Directive (AFID)

The original AFID focuses on the uptake of alternatively fuelled vehicles and their infrastructure. In March 2021, the Commission published a report to the European Parliament and the Council on the application of the AFID. The report finds that the AFID generally achieved its goals. However, it also points out that as there is no detailed and binding methodology for Member States to calculate targets and adopt measures, the level of ambition in target-setting and supporting policies varies greatly between Member States.

Against this backdrop, the Commission proposes for the AFID to take the form of a regulation, which means that the targets set for countries to deploy electric vehicle charging stations and hydrogen refuelling points will be binding. In this respect, it requires Member States to expand charging capacity in line with zero-emission car sales, and to install charging and fuelling points at regular intervals on major highways.

Revision of the Regulation Setting CO2 Emission Standards for Cars and Vans

The Commission has indicated that while CO2 vehicle standards have proven to be an effective policy tool, without further policy intervention emissions from road transport will not decrease at a satisfactory rate to reach the new 2030 target. The current regulation sets reduction targets of 15 percent for cars and vans to be achieved from 2025, and of 37.5 percent for cars and 31 percent for vans to be achieved from 2030, all compared to 2021.

Against this backdrop, the recast proposal provides that newly registered cars must have an average of 55 percent lower emissions by 2030, compared to 2021, and new vans 50 percent lower. Both new cars and vans must reach zero emissions by 2035.

A Carbon Border Adjustment Mechanism Proposal (CBAM)

The CBAM proposal aims to help reduce the risk of carbon leakage and ensure a level-playing field by encouraging non-EU countries to raise their climate ambition. Carbon leakage occurs when companies transfer production abroad to countries that have less stringent emission rules in place. Subsequently, in the absence of CBAM, carbon leakage would hinder the EU's efforts to become climate-neutral by 2050, relocating emissions to third countries rather than reducing global emissions.

The CBAM covers the following sectors: steel, iron, cement, fertiliser, aluminium and electricity. In essence, it will be applicable to imported goods from these sectors originating in countries and territories outside of the EU Custom Union, Iceland, Liechtenstein, Norway, Switzerland and the territories related with certain EU countries. Importantly, the proposal mentions that the European Commission can adopt delegated acts to extend the number of sectors not subject to the CBAM requirements.

On a practical note, the proposed CBAM is in essence an extension of the EU ETS to imports. This means that importers of in-scope goods would need to buy from a proposed CBAM authority. CBAM certificates corresponding to the emissions embedded in these goods during the previous year. The embedded emissions will have to be verified by an independent verifier. In case the actual emissions cannot be adequately verified, the number of CBAM certificates to be surrendered will be determined in accordance with default values. The CBAM Authority will calculate the price of CBAM certificates as the average of the closing prices of all auctions of EU ETS allowances conducted in auctioning platforms during each calendar week.

As regards imported goods from countries with a carbon price, importers may claim a reduction in the number of CBAM certificates to be surrendered corresponding to the carbon price paid in the country of origin for the declared emissions. In this regard, the importers will have to submit sufficient information, accurately certified by a competent independent person, that the declared emissions are subject to a carbon price in the country of origin of the imported good along with proof that such carbon price has been paid in the country of origin and cannot be subject to an export rebate or other form of compensation linked to the fact that the good is exported.

Concerning the CBAM's compatibility with World Trade Organization (WTO) rules, the proposal stipulates that the EU installations would continue to receive free allowances under the EU ETS. These free allowances will gradually diminish and entirely disappear by 2035. In this regard, in order not to undermine the CBAM's alignment with WTO rules, until free allowances are completely phased out in 2035, the CBAM will apply only to the proportion of emissions that does not benefit from free allowances under the EU ETS, thus ensuring that importers are treated in an even-handed way compared to EU producers.

As for its application date, the CBAM is scheduled to be introduced in 2023 and be fully operational by 2026. This means that importers will have to report emissions embedded in their goods without paying a financial adjustment in a transitional phase starting in 2023 and finishing at the end of 2025, giving time for the final system to be put in place.

NEXT STEPS

Today's proposals will have significant implications for companies doing business in Europe in virtually every sector of the economy. For some companies, these proposals will oblige them to take important strategic decisions on existing business practices. Other companies will have the opportunity to develop a sustainable competitive advantage.

Importantly, as Europe is leading the way in the race to net zero, it is also developing a regulatory first-mover advantage. This is expected to influence policymaking also outside the EU.

From a legislative perspective, the proposals will now undergo the legislative procedure, which normally lasts around 18 months (even more in some cases, as it may be the case with some of the most politically sensitive proposals included in this Package). This means that they will have to be reviewed by both the Council of the EU (Member States) and the European Parliament (relevant committees and then Plenary), who will then have to negotiate and agree on the final legislative texts.

Our K&L Gates Public Policy team in Brussels can assist companies in assessing the various proposals, and developing and executing on a strategic engagement plan to address any concerns arising out of the Fit for 55 Package.

KEY CONTACTS

GIOVANNI CAMPI
GOVERNMENT AFFAIRS ADVISOR

BRUSSELS
+32.(0)2.336.1910
GIOVANNI.CAMPI@KLGATES.COM

