



## **The Danish Government's position paper on an ambitious and cost-effective EU climate policy architecture – a response to the European Commission's public consultations on the EU Emissions Trading System Directive, Effort Sharing Regulation and the Land Use, Land Use Change and Forestry (LULUCF) Regulation**

### **The Danish Government's key priorities for EU's future climate policy architecture**

- **A strengthened EU Emissions Trading System (ETS) – ETS should be the central driver for future emission reductions.**
- **Extension of the ETS to road transport and heating in buildings – a more uniform price signal across sectors and the EU.**
- **An Agriculture, Forestry and Other Land Use (AFOLU) pillar with ambitious EU sector regulation providing incentives for effective, climate-friendly, and competitive land sector across the EU and ensuring delivery of an EU-wide climate target.**
- **A new architecture should be backed by ambitious and cost effective enabling regulation and supporting policies across sectors.**

### **A new climate policy architecture to deliver on EU's net 2030 climate target**

The European Council reached an important decision in December 2020 on a new net EU GHG target of at least 55 percent in 2030 compared to 1990 that will set the EU on the right track to become climate neutral by 2050. However, increasing the EU's climate ambitions is about more than setting an ambitious target. It is equally important to decide how to deliver on the increased ambition in the most cost-efficient way.

The European Commission's "Fit for 55 package" presents a unique opportunity to rethink and modernize the design and overall architecture of the EU's energy and climate policy. While the revision should ensure that the EU delivers the necessary reductions and removals by 2030, it should also enable the EU to deliver higher levels of climate ambition towards net zero GHG emissions by 2050 in an economically sustainable way. In addition, it will be equally important to implement the new policy framework in a timely way so it can contribute to a cost effective implementation of the 2030 target.

This will require a significant reform of the current policy architecture, which will take time and efforts to implement. The Commission's package must therefore ensure that the EU's climate regulation is set on the right track for a new policy architecture already now. Such a reform is a precondition for achieving both climate neutrality in a cost efficient manner to the benefit of Europe's citizens and businesses as well as the broader objectives of the European Green Deal to transform the EU to an even more sustainable and prosperous society.



The transition also brings multiple benefits in terms of well-being of citizens such as cleaner air, reduced pollution, and future-proof employment opportunities in green sectors and industries. It is a key task of EU's future climate policy to ensure that all Member States move forward and are able to reap the benefits of the green transition.

Higher climate ambition in 2030 should be implemented through equally ambitious and cost effective EU regulation that provides incentives to reduce emissions of greenhouse gases across all Member States and sectors of the European economy. The EU therefore needs a climate policy architecture that:

- **Delivers a stronger and uniform CO<sub>2</sub> price signal across Member States and sectors in the EU to ensure cost-effective reductions.**
- **Creates incentives for substantial carbon removal to get the EU on the right pathway towards climate neutrality by 2050 and to reverse the decreasing land carbon sink towards 2030.**
- **Ensures a level playing field and reduces the risk of carbon leakage.**
- **Generates revenue streams to finance the green transition and address distributional effects.**
- **Tackles market imperfections and support the development of new and innovative low and zero emission technologies and solutions.**

The current EU climate policy architecture creates large differences in the marginal reduction costs between the ETS and the 27 different national regimes in the Effort Sharing Regulation (ESR). Implementing an increased 2030 climate target by maintaining the current scope of the ETS and ESR would likely exacerbate these differences and result in unnecessarily high costs of climate mitigation in the EU. This is neither beneficial for the climate nor the European economy.

In this light, the current EU climate policy is not only unfit to deliver on the increased target, the climate architecture is also not fit for delivering the EU's increased climate target in accordance with the objectives of the Green Deal.

The Danish Government therefore encourages the Commission to present an improved EU climate policy architecture in the "Fit for 55 package" through the elements listed below. In creating such a new modernised policy framework, it will be important to take into account the effect of a strong CO<sub>2</sub> price across sectors and thereby ensure the right balance between a strong CO<sub>2</sub> price and regulatory instruments as well as making sure that they serve the same end goal.



### **A strengthened EU Emissions Trading System – the central driver for future emission reductions**

The EU Emissions Trading System (ETS) has demonstrated its worth as the EU's flagship climate policy instrument. Following the 2018 revision of the ETS directive, it has succeeded in establishing an effective EU-wide carbon price signal that has improved incentives to reduce emissions cost-effectively across Member States. In 2019, emissions covered by the ETS fell by 9 percent compared to 2018 levels. The Danish Government strongly supports the Commission's approach to strengthening the ETS as the key tool for reducing EU GHG and achieving the EU's climate targets.

An effective and predictable carbon price is the most cost-effective instrument to deliver an enhanced EU climate target and to incentivise market-driven deployment of zero-carbon technologies and the phasing-out of fossil fuels across Europe. The rapid cost reductions of renewable energy technologies in particular wind and solar enables the sectors currently covered by the ETS to deliver a substantially increased contribution to the EU's 2030 climate target at low costs. The Danish Government thus encourages the Commission to ensure that the new EU 2030 climate target will be reached by as much CO<sub>2</sub> reduction through the ETS as possible.

#### *Adjusting the emissions cap to deliver the EU target*

For the ETS to deliver the reductions needed as well as the necessary it needs to be upgraded and strengthened significantly. This means addressing both existing structural issues that have led to a build-up of a large amount of surplus allowances as well as increasing the overall ambition level through a two-tiered approach:

- Setting a binding emissions cap to ensure a sufficient level of emission reduction. The current emissions cap trajectory is set far above actual emission levels, leading to a continued build-up of a surplus of allowances that is set to continue well into the ETS phase IV period. Therefore, the Commission is encouraged to propose a one-off rebasing of the starting point of the emissions cap that reflects the level of the average actual emissions along with an increased linear reduction factor reflecting an ambitious contribution from the ETS to the EU's climate target in the year 2030. A one-off rebasing should be set as early as possible in the new period.
- Improving the ability of the Market Stability Reserve to limit the surplus of allowances. Even with the above proposals for strengthening the emissions cap, the surplus of allowances in circulation could remain at a level that would allow emissions in the ETS potentially to go far above an emissions cap aligned with the 2030 climate target. The Commission is therefore encouraged to present a proposal to change the MSR rules and design features to address the build-up of surplus of allowances. This could include both maintaining the 24% withdrawal rate and reducing the MSR thresholds to a lower level.



### *Ensuring an effective CO<sub>2</sub> price signal at a minimum level*

A substantial reduction of the level of allowances available to the market should be the main instrument to strengthen the ETS. While the EU has succeeded in creating a credible carbon market, experience shows that the effectiveness of the ETS has been challenged by changing economic circumstances, the effect of overlapping policies and unforeseen technology developments. With the expansion of the ETS to new sectors, it will be important to preserve the credibility of the ETS as an effective tool to reduce emissions against new and unforeseen developments. The ETS should thus be able to withstand future shocks, which affect the demand for allowances. In this light, the Commission is encouraged to explore options for ensuring a CO<sub>2</sub> price signal at a minimum level to provide certainty for green investments such as for example an auction reserve price.

### *Integrating negative emissions technologies in the ETS*

Substantial removals of CO<sub>2</sub> from the atmosphere are needed to reach national climate targets, the 2030 climate target of at least 55 pct. as well as the EU's objective of climate neutrality by 2050. While natural sinks can deliver significant removals, it is likely that technological solutions for carbon capture and storage (CCS) delivering so-called negative emissions will also play a significant role in the efforts to achieve climate neutrality by 2050. Consequently, the Commission is encouraged to present policy options for further incentivising the development and deployment of these technologies.

This could be achieved by including negative emissions technologies in the ETS – for example by allocating allowances to installations that generate negative emissions certificates based on the development of robust and transparent carbon accounting or other similar measures.

### *Review of the rules on free allocation of allowances in the ETS*

It is important to ensure a level playing field and thereby avoid leakage risks through effective and focussed measures. The Commission is encouraged to assess the adequacy of carbon leakage measures and review the level of free allocation of allowances in the ETS in light of the proposal for an EU Carbon Border Adjustment Mechanism (CBAM).

It is essential that the EU's future framework for addressing carbon leakage is consistent and fully compatible with the WTO rules, avoiding double compensation. Therefore, a phasing in of a CBAM for specific sectors should result in a simultaneous phase-out of free allocation of allowances for these sectors. Furthermore, to ensure a level playing field, a CBAM should reflect the EU CO<sub>2</sub> price and seek to take into account emissions involved in production and any carbon costs already incurred by imports from jurisdictions with their own carbon pricing regimes.

The Danish Government welcomes the Commission's intention to present options for adjusting the share of allowances auctioned for aircraft operators with a view to



ensure further reductions of greenhouse gas emissions and a level playing field with other modes of transport.

#### *ETS state aid*

The ETS State Aid Guidelines for ETS phase IV has just been adopted. The possibility to use state aid was, however, in ETS phase III designed as a transitional measure only and was never intended as an opportunity to delay the efforts that Member States should put in place in the transition to energy supplies based on renewable energy. For that reason, it is important for the Commission to make sure that the ETS state aid is phased out by the end of ETS phase IV in 2030 or soonest possible thereafter.

#### **Extension of the ETS to road transport and heating in buildings to deliver emissions reductions through a more uniform price signal across sectors**

While the EU ETS has reduced emissions effectively, there is still a considerable untapped reduction potential in the sectors covered by the Effort Sharing Regulation. EU road transport emissions have increased by more than a quarter since 1990, while EU emissions from heating of buildings have decreased but with substantial variation across EU Member States.

The Danish Government therefore encourages the Commission to follow through with the intention presented in its 2030 Climate Target Plan and Renovation Wave to extend the ETS to road transport and heating in buildings to create one single system covering all emissions from combustion of fuels in these sectors. Extending the ETS to these sectors brings several advantages:

- Increases certainty of delivering sufficient GHG emissions reductions. The financial penalties under the EU ETS in case of non-compliance apply directly to the emitting entities and therefore ensure high certainty to deliver the environmental outcome.
- Increases cost-effectiveness. Creating a uniform price signal across these sectors incentivising both a switch of fuels for heating in buildings and uptake of low carbon mobility technologies, while improving the overall cost-effectiveness of the EU's climate efforts.
- Addresses distributional effects effectively. While carbon pricing in heating in buildings and road transport is expected to have distributional effects, an extension will significantly increase the revenue from auctioning of allowances and thereby create a significant and predictable revenue stream to support the transition in Member States. Revenues could be used to tackle distributional effects caused by increasing costs for households related to carbon pricing. In comparison, alternative types of regulation and policies can also have considerable implicit distributional impacts, without generating the financial means to tackle such challenges. The distributional effects should also be seen in the context of



the significant funds in the Multiannual Financial Framework and the Next Generation EU that can contribute to the Renovation Wave.

- Strengthens the joint effect of carbon pricing and complementary policies. Extension of the ETS is likely to strengthen the joint effect of carbon pricing and complementary policies such as standards by enhancing efficiency and focusing attention on how to target standards and other regulatory measures to challenges where carbon pricing alone could be insufficient. As an example, it supports overall intensification of energy efficiency measures, notably by putting a price on carbon emissions incentivizing cost-efficient building renovations. EU eco-design standards for energy use in electrical appliances have worked effectively in combination with the EU ETS.

An extension of the ETS to heating in buildings and road transport will consequently reduce the role of the Effort Sharing Regulation significantly and it should therefore be phased out.

#### **Extension of the ETS to the maritime sector**

Shipping accounts for approximately 2% of the world's greenhouse gas emissions. There is both a need and a real potential to decarbonise the sector. The Danish Government supports a safer, smarter and more sustainable future for shipping, and like all other sectors, the maritime sector needs to reduce its GHG emissions and contribute to the transition towards a climate neutral economy.

It will require the right mix of policy action to trigger the necessary innovation and investments in infrastructure. Carbon pricing on shipping has to be combined with a suite of other policy tools to ensure a sustainable transition of shipping. The Danish Government looks forward to discussing the initiatives expected by the Commission in 2021 e.g. as part of its Strategy on Smart and Sustainable Mobility.

When it comes to an EU level measure for shipping, including ETS, the Danish Government finds that it must adhere to the following principles in order to ensure the best possible outcome for the European maritime industry and to ensure actual emission reductions from shipping based on the principles mentioned below:



- Carbon leakage has to be avoided.
- A global level-playing field must be maintained. Consequently, an EU measure must be flag neutral and enforceable.
- EU measures should support global level measures within the IMO, avoid double regulation and not stand in the way of any future global solutions.
- EU measures should incentivize further innovation, promote first-movers and ensure an accurate baseline.
- EU measures should take the international nature of shipping and the low predictability in the sector from year to year into account.
- EU measures should consider shipping within the context of an energy efficient European transport system.

The attached Annex I contains an elaboration of preliminary suggestions for an EU ETS for shipping, which the Danish Government has also submitted as part of the Commission's targeted "Stakeholder consultation on the revision of the Emissions Trading System in relation to maritime transport".

### **A strong and coherent enabling framework with sectoral regulations and policies**

As the Commission states in its 2030 Target Plan, policy measures interact and these interactions are likely to intensify when the intensity and scope of the climate policy changes. A strengthened and extended ETS will be a strong legislative tool, but a carbon price needs to be complemented by an ambitious and cost effective enabling framework with coherent policies and regulations not least to address market failure such as barriers to the deployment of low and zero carbon technologies etc.

The Commission is encouraged to make sure that the update of this enabling framework is carried out in a consistent manner, which creates a policy mix where all relevant regulation serves the same end goal and complements an effective carbon pricing. It will be equally important to ensure that the instruments underpin the same incentives and utilises synergies across the legislative instruments, while avoiding overlaps.

This includes for instance strengthening CO<sub>2</sub> emission performance standards for light and heavy-duty vehicles to drive the technological development of zero-emission vehicles as well as strengthening EU legislation to enable renewable heating in buildings, energy renovations in buildings as well as an ambitious large scale expansion of renewables. In addition, a revised Energy Taxation Directive should be designed to complement a revised ETS and thereby also the phasing out of fossil fuels.



There is also a need to obtain a coherent approach on creating the right incentives to further develop and deploy sustainable and renewable fuels across the regulation and initiatives of the “Fit for 55” package, including through the ETS. The Danish Government see a particular potential in renewable hydrogen in achieving climate neutrality in sectors where abatement costs are high. Therefore, in the context of the ETS revision the Commission is invited to consider solutions to overcome the disincentive to invest in renewable hydrogen due to the free allocation of allowances to fossil-based hydrogen with the purpose of creating a level playing field for green technologies.

*A new monitoring, reporting and verification system – limiting administrative impacts of an extended ETS*

The Commission is encouraged to ensure that the new monitoring reporting and verification system followed by an extension of the ETS to new sectors is implemented in a way, which to the extent possible limits additional administrative costs for national administrations and enterprises. As the Commission mentions there seems to be an obvious advantage in using the existing ETS administrative infrastructure already in place for an extended ETS system.

In order to achieve a coherent and compatible approach to monitoring emissions from transport of CO<sub>2</sub> for utilisation or storage, the definition of “CO<sub>2</sub> transport” in the Monitoring and Reporting Regulation could be broadened accordingly. The establishment of an activity-specific monitoring methodology for CO<sub>2</sub> transportation by water, road and rail is considered a necessary addition to the existing suite of guidelines for capture, transport by pipelines and geological storage. This will ensure a more robust and consistent framework and set a clear price signal to investors and create a market for these types of technologies that does not exist today.

**AFOLU pillar with an ambitious sectoral climate regulation to provide incentives for an effective, climate-friendly and competitive land sector across the EU and ensuring delivery of an EU-wide climate target**

An extension of the ETS to road transport and heating in buildings would leave agriculture as the primary sector regulated through national targets under the ESR and thus have major impact for the ESR in its current form. Agriculture will account for an increasing share of EU emissions as the rest of the economy decarbonises. Efforts to reduce emissions from agriculture vary considerably between Member States due to differentiated national reduction targets, and an extension of the current architecture would come with unnecessarily high costs. The Danish Government therefore encourages the Commission to propose a combined AFOLU pillar with an EU-wide reduction target.

Establishing an AFOLU pillar with an EU-wide climate target accompanied by ambitious and effective sector regulation would contribute to aligning the EU climate architecture for land-related emissions and removals of greenhouse gases with the new EU 2030 climate target and the objective of climate neutrality by 2050. The EU





should work towards realising the vision of an AFULO pillar with the proper incentives in place for producers to make sustainable decisions. A combined AFOLU sector would allow for a more integrated and cost-effective mitigation effort with many significant advantages to the climate as well as the economy.

Please refer to the attached Annex II for an elaboration of these views, which has also been submitted by the Danish Government in parallel to the European Commission's public consultation on the review of EU rules concerning Land Use, Land Use Change & Forestry.