FIT FOR 55: THE LONG REACH OF EU'S AMBITIOUS CLIMATE PACKAGE

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In a fundamental step change providing a clear signal to businesses that they will need to start changing rapidly, the EU has tabled its ambitious "Fit for 55" package as part of its Green Deal and in advance of COP26.

The package sets an ambitious 55% greenhouse gas (GHG) reduction target for 2030 (as compared to 1990 levels). It contains a comprehensive round-up of amendments to existing energy, climate, transport and trade measures, as well as a slew of new measures, including emissions trading covering buildings, road transport and shipping, and a carbon price on imports.

These will impose significant, binding obligations that the EU will enforce against Member States if needed, meaning business operating in or selling into the EU need to take these hard-edged changes into account now when making decisions, as national governments will be compelled to see them through. It will have significant impacts across all sectors of the economy once in force, and businesses that start to react now can be well placed to not only survive the coming transition, but to thrive.

Fit for 55

In late June, the EU for the first set into law binding targets for 2030 and 2050, with a trajectory for reaching both. Although carbon reduction is the headline, the package cuts across many aspects of EU policy and amounts to a roadmap for decarbonising a continent. In the process, the EU has cast its green deal and its growth strategy as one and the same. This is a significant upping of the ante, as anyone operating in or dealing with the EU will need to adjust to the new marching orders or find themselves shut out.

The elements likely to have the highest impact are the tightening of the carbon limits allowed under the EU Emissions Trading System; the introduction of the Carbon Border Adjustment Mechanism (CBAM) to clamp down on 'carbon leakage'; and the new targets in the Effort Sharing Regulation, all three of which apply principally to high carbon sectors.

Through the combination of those three measures, large swathes of EU economic activity will need to reduce their carbon outputs significantly within the next 10 years and completely by 2050. Non-EU counties like the UK, US and China that want access to the bloc will have to follow suit, and companies that might previously have moved out-of-jurisdiction will find this does little to lower the standards placed on them when dealing in or with the EU. In a similar vein to the Corporate Sustainability Reporting Directive and Sustainable Finance Disclosures Regulation, EU requirements reach well beyond Member States' borders, and many third countries have also taken steps to match or exceed the EU's lead.

Fit for 55 has received support from sections of the business community, although some industry groups remain opposed. The Corporate Leaders Group, which brings together a number of green networks including the European Green Growth Group and We Mean Business as well as IKEA and Unilever, has called the package a "once in a lifetime opportunity to deliver the transition to a net zero economy". They argue that "action now will boost a green, digital and inclusive economic recovery in the wake of the covid-19 pandemic and develop EU economic strength in the growing new industries and clean markets of the future".

The package is still going through the European legislative process and will apply in law from 2024 at the earliest. However, the timing of the announcement sends a clear signal to the world and to business in advance of COP26.

In summary, the package includes:

- Tightening the cap on emissions allowed under the **EU Emissions Trading System** (ETS), which covers about 40% of the EU's total greenhouse gases, to target a 55% reduction in 2030 (vs 40% currently).
- New targets in the **Effort Sharing Regulation** (ESR), which covers the other 60% of EU emissions, specifically agriculture, transport, buildings and waste.
- A €72 billion **Social Climate Fund** to address the social impact of the new ETS levels, with possibly 50% of ETS revenues going towards it.
- The new **Carbon Border Adjustment Mechanism** (CBAM), to be brought in for 2026, to protect European business from 'carbon leakage' in respect of high carbon areas like cement, fertilisers, iron, steel, aluminium, and electricity.
- The percentage of renewables required under the **Renewable Energy Directive** increasing to around 40% by 2030 as an average across the EU (vs 32% under the current target set in 2018).
- The 32.5% energy efficiency savings target under the **Energy Efficiency Directive** becoming mandatory and increasing to 39%. There is also pressure to increase the current target of 3% renovations for public buildings.
- Amendments to the **Energy Taxation Directive**, to increase minimum rates for energy products like heating, transport fuels and electricity; and to change oil & gas taxation (which currently benefits from tax breaks totalling around €35 billion).
- Amendments to the **Alternative Fuels Infrastructure Directive** to promote increased interoperability of electric vehicle charging infrastructure and make pricing more transparent, with the aim of 3 million charging points by 2030.

The likely requirement for **new cars** to show a 60 - 90% cut in emissions by 2030 and all new combustion engines being banned by 2035.

Introduction of '**ReFuelEU Aviation**' and '**FuelEU Maritime**', which aim to green jet fuel and decarbonise shipping through sustainable fuel alternatives.

A new EU forestry strategy with a focus on stronger governance, reaching climate neutrality in the **land use, forestry, and agriculture** sectors by 2035, and the aim of planting three billion trees across Europe by 2030.

Another package is due in December covering building efficiency rules and gas markets.]

A policy with teeth

The broad focus and relatively ambitious targets will have significant impacts for all businesses across the bloc and outside it, and it is substantially different from measures that might originate at national or international level. This is due to the binding rather than voluntary nature of EU targets, and the fact that they can be enforced via the EU's extraordinarily powerful - although sometimes slow - 'infraction' mechanism.

Fit for 55 therefore represents a fundamental step change and a package of measures that, given the direction of travel, are unlikely to be watered down once in force. Business should look to adapt now in order to be well placed to take advantage of the coming changes. Sooner rather than later, the overall target will affect all business, with high-carbon sectors being affected the most first.

The new interim target for 2030 means that business must also consider whether decisions they are making today risk locking them into pathways that will be inconsistent with the 2030 targets. They will want to consider carefully, now, what impact Fit for 55 might have on their business model, governance, supply chains, reporting and investment decisions in order to stay ahead of - or at least in line with - the global shift towards a lower carbon economy.

The Fit for 55 package also represents a significant opportunity for businesses, particularly in sectors targeted for growth. For example, in relation to energy-related investments, the EU will need to invest €350 billion more annually in the period 2021-

2030 than it did in the period 2011-2020, an increase of around €90 billion per annum compared to the investments needed to achieve current 2030 climate and energy targets[1].

Although limited to the EU, the package is a central aspect of the EU's negotiating position at COP26 and may set the standard beyond Europe. Measures like CBAM in particular will force countries outside the EU to respond or risk losing out.

The EU has said it will engage with all sectors of the economy that decide to prepare indicative voluntary roadmaps towards achieving net zero and look to facilitate dialogue. Those that do not tempt further statutory measures being brought in that may be less desirable from an industry perspective. In the meantime, the European Scientific Advisory Board on Climate Change will provide independent scientific advice and reports on EU measures, climate targets and greenhouse gas budgets and the extent to which they are consistent with European climate laws and international commitments under the Paris Agreement.

Increasing the pressure

Whilst climate-related legislation in the past could be seen to target specific sectors, the breadth of the Fit for 55 package and its 2030 targets mean that, although high-carbon sectors will be the first to be effected, its impact will be felt in all parts of the economy. This breadth means businesses will increasingly need legal advice that goes beyond just their disclosure obligations and instead touches on what they are doing actively in respect of climate change as well as reporting and transparency.

The package sends an important message regarding the direction of EU policy. When implemented, the package is expected to stimulate investment in markets such as renewables, fuel switching and energy efficiency. It is likely to embolden shareholders, asset managers, and financial institutions to demand more of those in which they invest and to whom they provide finance, as they are already starting to do. As all organisations and stakeholders come under pressure to account for their climate action or otherwise, they will look to draw in those around them and to put in place effective policies and processes for transitioning towards 2030 and 2050.

The new targets will also likely see the trend of climate litigation brought by NGOs and citizens against countries - and sometimes companies - continue. The increased ambition contained in the targets, and the much closer time horizon, mean it's more likely that potential claimants will see cause to challenge the action being taken for being too slow.

Building momentum towards a low carbon economy

Taken together, Fit for 55 is likely to have a significant impact on the role of fossil fuels in the EU economy and drive demand towards alternatives:

- The headline carbon reduction targets reflect an increased level of ambition that will leave substantially less space for continued oil & gas use. By imposing a binding target of keeping energy use in 2030 to 39% below projections - as opposed to current non-binding 32.5% target - the overall reduction would be around 100 million tonnes of oil equivalent.
- The recalibrated EU ETS, Effort Sharing Regulation and CBAM will work in combination to increase carbon prices by capping emissions in high-carbon industries and preventing leakage overseas to avoid those caps, forcing emitters to find ways to reduce emissions, such as through fuel switching.
- The Renewable Energy Directive will promote more renewables on national energy grids and the Alternative Fuels Infrastructure Directive will put in place the electronic vehicle infrastructure to make even more use of it.
- New cars will need to emit less and will therefore have to move away from burning hydrocarbons.
- The Energy Efficiency Directive should reduce energy demand from buildings.
- In addition, the tax treatment for fossils fuels will become less favourable and the treatment of electricity conversely more amendable.

[1] EU Commission, Climate Action Plan, 2020

There is a role for continued use of fossil fuels as a transition fuel and demand may continue in some sectors, coupled with carbon capture technology or with offsets. However, the Fit for 55 package sends an important investment signal, particularly given the scale of investment that will be needed. Business-as-usual is incompatible with the Paris Agreement and now too with the vision of a transitioning European Union.

The package in more detail:

EU Emissions Trading System (EU ETS)

A cornerstone of the Fit for 55 package is the substantial revision of the EU ETS to take account of the higher level of ambition for carbon reductions by 2030. Proposals include:

- lowering the emissions cap in line with the new 2030 target.
- extending the EU ETS to the maritime sector over the period 2023 to 2025.
- phasing out free allowances for the aviation sector.
- introducing a separate emissions trading system for road transport and buildings. This will be done in a separate system focused on upstream fuel suppliers which will be operational from 2026.
- introducing a carbon border adjustment mechanism (CBAM) by 2026 - see further below - and end free allowances in those sectors covered by CBAM.

Together, these measures are likely to result in an increase in European Union Allowance prices, which ultimately will be passed onto consumers in higher prices for goods and products.

Effort Sharing Regulation (ESR)

The ESR looks to "share" the effort of addressing emissions from buildings, transport, agriculture, waste and small industry across the EU Member State. Fit for 55 looks to tighten up existing ESR targets to deliver an EU-wide reduction of 40% in emissions from these sectors by 2030 against 2005 levels. National targets are based on GDP per capita to reflect each Member State's ability to act, with adjustments made to take national circumstances and cost effectiveness into account.

The EU hopes that broadening out the ESR's scope will drive changes in public and private investments, consumer behaviour and business practices towards less carbon, in lieu of much stronger regulation of the sectors within scope (eg in fuel standards, renewable energy, energy efficiency and taxation especially.

Carbon border adjustment mechanism (CBAM)

CBAM would require all non-EU countries, non-EEA countries, and Switzerland to report emissions embedded in the aluminium, cement, iron, steel, electricity and fertiliser products they import, and to buy certificates to account for them. The aim is to minimise 'carbon leakage' from producers relocating outside the EU simply to avoid its stringent carbon requirements, and would complement the EU ETS. The mechanism would start to come into effect from 1 January 2023 with full implementation by 1 January 2026.

The EU's impact assessment found that CBAM should reduce carbon leakage by almost a third by 2030, amounting to a 1% reduction in EU emissions overall. The proposed revision to the ETS would incrementally remove the free allowances given to the sectors most at risk of carbon leakage, between 2026 and 2025.

CBAM has already created international friction and will continue to do so. The Commission has stated it is designed to comply with the World Trade Organisation's non-discrimination rules. However, that does not mean challenges won't be brought forward in the face of a perceived infringement, and the EU may have to rely on diplomacy or an environmental exception under GATT. For example, Article XX(b) or (g), which allow for "protection of human, animal or plant life or health" and the "conservation of exhaustible natural resources", although there would be a high threshold for success of any defence relying on these exceptions.. Already, the US and China have expressed concerns.

There is a good chance that the UK will develop its own version of CBAM to mirror moves at EU level as it has done on a number of other climate change fronts. Russia, Turkey and China are the trading partner countries mostly likely to be hardest hit under the current proposals (but can ameliorate this by introducing their own carbon pricing policies which the CBAM would then take into account).

Social Climate Fund

Accompanying the introduction of emissions trading for road transport and building, the Social Climate Fund looks to offset the additional burden that might have on those most at risk of energy and mobility poverty, by providing dedicated funding. The EU describes this as an effort to ensure a just transition, and no doubt is in part a response to the concerns that initially drove the gilets jaunes.

The fund is to provide €72.2 billion from 2025 to 2032 to "vulnerable low and middle-income households, transport users, and micro-enterprises" affected by building and transport emissions trading. Support is expected to flow towards investments to increase energy efficiency in buildings, clean heating and cooling, and integrating renewable energy in a way that sustainably reduces CO2 emissions and energy bills for vulnerable households and micro enterprises. It will also finance access to low or zero-carbon transport.

Renewable Energy Directive

Deeper decarbonisation requires the revision of the EU's 2030 target for renewable energy in final consumption of at least 32% by 2030 set out in the Renewable Energy Directive (recast) 2018/2001 (RED II). The Fit for 55 package proposes a new target of 40%. This target is only binding at the EU level (as before), but the Commission proposes that the EU target is complemented by indicative national contributions, showing what each Member State should aim for to reach the collective target. The scale of the ambition cannot be overstated: the revised target effectively requires a doubling of the share of renewables in the EU's energy mix in the next decade.

The Fit for 55 package also revises the renewable energy sector sub-targets including:

- a new indicative EU-wide target of 49% of renewables in energy consumption in **buildings** by 2030.
- new targets for renewable energy in **industry**: an indicative target of an annual average increase of renewable energy of 1.1 percentage points (ppts) and a binding target of 50% for renewable fuels of non-biological origin (RFNBOs) (such as electrolytic or green hydrogen) used as feedstock or as an energy carrier.
- increasing the target for **heating and cooling** from 1 ppt to 2.1 ppt of energy from renewable sources and from waste heat and cold in district heating and cooling.
- increasing the target for renewables in **transport** by setting a 13% greenhouse gas intensity reduction target, increasing the sub-target for advanced biofuels incrementally up to 2.2 % in 2030, and introducing a 2.6% sub-target for RFNBOs.[2]

In addition to the revision of the renewable energy target and sector sub-targets, a number of other measures are proposed to facilitate the integration of renewables into the economy. These include changes to the guarantees of origin scheme, tighter restrictions on biomass generation, better labelling of renewable energy used in industrial products, greenhouse gas emissions saving criteria for RFNBOs (such as green hydrogen) and recycled carbon fuels, measures to promote the entry into of corporate renewable power purchase agreements, and obligations to improve cross-border cooperation.

Whilst many of the proposals may appear highly technical, as has been seen with the 2009 renewable energy directive, the revision of RED II is expected drive investment in renewable energy, alternative fuels and in related infrastructure. As a result, if adopted, it is pivotal for the EU's economy.

Energy Efficiency Directive (EED)

The changes to the EED would see annual energy savings obligation for Member States almost double, along with a target for the public sectors to renovate 3% of its building each year to bring down energy usage.

Energy Taxation Directive (ETD)

The proposed revision to the ETD is to align minimum tax rates for heating and transport fuels with EU climate objectives whilst mitigating negative social impacts. Exemptions for aviation and maritime transport, for example, will be removed, as will incentives for the use of fossil fuels, in favour of promoting the uptake of clean fuels. There will be a move away from volume-based taxation to focus on energy content and environmental performance so that the greatest pollutants bear the highest rates of tax.

[2] For proposals relating to fuel switching in the aviation and maritime sectors, please see the ReFuelEU Aviation' and 'FuelEU Maritime' section below.

Relatedly, in reviewing the State aid guidelines for environment and energy, the Commission has said it will pay particular attention to making sure they mirror the ambition and scope of the EU's Green Deal.

Alternative Fuels Infrastructure Directive (AFID) and vehicle emissions standards

Tighter emissions standards for cars and light commercial vehicles have been proposed that would require emissions from new cars to drop by 55% in 2030 and 100% by 2035 against 2021 levels, reflecting the average life of cars in service today. In effect, this means no new internal combustion engines and the need for a dramatic shift towards producing electric vehicles and the infrastructure that will support them. Other types of vehicle would not be affected (yet).

The AFID accordingly also imposes an obligation on Member States to install interoperable and user-friendly charging points for electric cars and hydrogen pumps and aims to help drive update on non-fossil fuel burning vehicles, in conjunction with higher carbon prices.

'ReFuelEU Aviation' and 'FuelEU Maritime'

As a complement to the ETS, the Commission has also proposed measures to promote the uptake of sustainable aviation and maritime fuels, which the International Maritime Organization and Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) are also promoting.

Jet fuel would be greened by imposing a 'blending mandate' requiring all aircraft leaving the EU to refuel using green jet fuel, building incrementally to 63% in 2050. The upcoming Zero Emission Aviation Alliance will also work to ensure market readiness for aircraft configurations based on hydrogen and electricity.

Ships would be made more sustainable by imposing a limit on the greenhouse gas content of the energy they use, regardless of their flag and whether they are coming to or going from the EU.

Both measures are complemented by the revised Energy Taxation Directive, which will close loopholes for polluting fuels and make cleaner fuels more attractive, including imposing a minimum rate of tax on aviation fuels used for intra-EU business and pleasure flights (cargo flights and those to international destinations would be exempt).

Land Use Land Use Change and Forestry Regulation (LULUCF)

As the EU states "the twin climate and biodiversity crises cannot be treated in separately… we either solve the climate and nature crises together, or we solve neither". The bloc is therefore aiming for climate neutrality in land use, forestry, and agriculture by 2035 through a natural carbon sink target and a plan to plant three billion trees across Europe by 2030.

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