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The European Commission's "Fit for 55" Proposals – Implications for Industry and the Environment

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On July 14, the European Commission announced its latest effort to advance the European Union's environmental legislative agenda: *"Fit for 55": Delivering the EU's 2030 Climate Target on the way to Climate Neutrality.* Fit for 55 is a series of legislative proposals designed to eliminate fossil fuel dependency across the EU's 27 member states. In this Alert, we discuss these proposals and their implications for industry and the environment.

Leading up to Fit for 55

The blueprint for the European Union's (EU) modern climate and decarbonization agenda was established in the 2019 European Green Deal, with the goal of being net-zero by 2050. In furtherance of that goal and the EU's contribution to meeting the goals of the Paris Climate Agreement, in December 2020, the European Commission informed the United Nations Framework Convention on Climate Change that it was committing to a 55% reduction in greenhouse gas (GHG) emissions by 2030, as compared to 1990 levels. This commitment became binding legislation with the passage of the European Climate Law, which took effect this month. Continuing that momentum, the newly issued Fit for 55 proposals set forth concrete measures designed to achieve the targets set forth in the European Climate Law.

A High Level Overview

Fit for 55 sets forth a multi-prong strategy for achieving decarbonization, focusing significantly on carbon pricing, market-based mechanisms, and standards.

The proposals include revisions to several existing EU directives and regulations, as well as the introduction of new requirements, which will have implications for a myriad of industries, based both in and outside EU member states.

Existing directives and regulations that would be revised include those relating to, among other things, renewable energy, energy efficiency, carbon markets, energy taxation, climate effort sharing between member states, land use changes, forestry, and automobile emission standards. New mechanisms that would be created include a carbon border tax and a new trading market for the transport and building sectors.

This Alert concentrates on key takeaways in the Plan that are most likely to have a significant impact on markets, market actors, and industry within Europe and abroad, through the following lens: (1) efforts to decarbonize economies by making the continued manufacture, use of, or reliance on, fossil fuels prohibitively expensive, or in certain cases, banned, versus (2) decarbonization initiatives that focus on incentivizing the use of "green" alternatives and carbon capture strategies.

Decarbonization by Prohibition

The measures discussed below are designed to reduce GHG emissions across the European Union by prohibiting the use of, or limiting access to, fossil fuels as an energy source. The measures do this through: (1) the phasing out of certain materials and products/technologies; (2) increasing the number of sectors subject to market-based schemes (and therefore held to industry emissions' reduction targets); (3) increasing emissions targets for all member states; and (4) changes to tax laws designed to more stringently regulate polluting energies. Specific proposals include the following:

- Phasing out of fossil fuel energy sources in the automotive and electricity sectors.

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One of the most noteworthy proposals is to end sales of all combustion engine automobiles by 2035. Other fossil fuel sources of energy also are targeted, such as via a plan to phase out coal from electricity generation.

- A revised *and* expanded EU Emissions Trading System (ETS).

  The ETS sets limits on overall emissions for certain industries, and then allocates tradeable credits accordingly. The existing ETS covers approximately 40% of the EU's total GHG emissions. The new proposals would increase covered emissions to 61% by 2030, as compared to 2005 levels. This would be achieved by (1) expanding the scope of covered sectors (e.g., adding shipping), (2) phasing out free emission allowances for the aviation industry between 2023 and 2025 and (3) the creation of a new and separate ETS for fuel distribution for road transport and buildings beginning in 2026.

  Depending on the stakeholder, the changes associated with the ETS can be viewed as punitive *or* an incentive. Many environmental groups have already expressed concerns that expanding the ETS, while still providing free credits and a long runway before phase-out, gives even more industries a way to avoid making real cuts to their actual footprint for another decade.

- Changes to Effort Sharing Regulation (ESR).

  Industry emissions not captured by the ETS are regulated through the ESR. The ESR apportions climate responsibility, in the form of emissions reduction targets, between member states. Responsibility is divided based on a member state's per capita contributions, taking into account its starting point and capacities. Proposed revisions to the ETS assign strengthened emissions reduction targets to each member state, for an overall increase in GHG reductions of 10% to 11% (above existing targets) for emissions from the buildings, road and domestic maritime transport, agriculture, waste, and small industry sectors.

- Targeting "polluting" energy through taxation.

  One such proposal targets polluting energy with an amendment to the European Union's tax code. Currently, all fuels in the EU are taxed based on volume. Under the Fit for 55 proposal, fuels would be taxed based on energy content, meaning that the most polluting fuels would be taxed the highest. Another proposal would add a tax on all aviation fuel, beginning in 2025, for all intra-EU flights, and would require all but the smallest airports to use greener fuels by 2025. Additional proposals include (1) updating minimum rates, (2) omitting certain tax exemptions, including for shipping fuels and (3) omitting rate reductions from a national government.

  Unsurprisingly, the proposals to change existing EU tax laws are considered some of the more controversial and likely to face significant opposition by member states, with limited exceptions. For example, the carbon border adjustment mechanism, which is further discussed below, is largely supported by industry within the European Union and is only controversial for trading partners/competitors outside the European Union.

Decarbonization by Promoting Alternatives Energies and Carbon Capture

While all Fit for 55 proposals are designed with the same objective (overall reductions of GHG emissions in the European Union), the proposals discussed below focus less on actions targeting polluting energy and more on efforts promoting cleaner energies. These proposals use various approaches to mitigate negative impacts on industry that could be associated with decarbonization efforts and, in certain cases, seek to increase opportunities for growth in certain sectors.

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- Carbon Border Adjustment Mechanism (CBAM).

  Also known as the carbon border tax, the CBAM has received more attention in the press than any other aspect of Fit for 55, largely because this proposal would have the most significant, and potentially negative, impact on those outside of the European Union. Because the effects of the CBAM on EU member states and EU-based industry generally are beneficial, it is included in this section and not in the prior section.

  The new proposal would tax imports of certain categories of high-polluting goods based on their carbon content (in other words, emission-intensive goods), unless the product is from a country with a similar measure in place. The CBAM would ensure that emission-intensive goods sold or used within the EU marketplace have prices reflective of the true cost, which includes the product's carbon content. Because the European Union already places a premium – or will do so through Fit for 55 (where gaps exist) – on emission-intensive industries such as cement, ammonia, iron, steel, aluminum, fertilizer, and electricity, the effect of the CBAM would be to level the playing field across the EU marketplace, ensuring that the specified high-polluting goods *all* have a price reflecting their carbon content, whether produced domestically or imported.

  Many countries, as well as the emission-intensive industries (noted above) located outside the European Union, have already objected to the proposal, arguing it is trade protectionism in violation of the requirements of the World Trade Organization (WTO). According to the European Commission, the gradual nature of program implementation and phasing out of quotas has been designed to comply with WTO requirements. There is a two-year mock run (2023 to 2025) before the program officially begins in 2026, and it will not be fully implemented until 2035.

- Updates to the Renewable Energy Directive (RED) and the Energy Efficiency Directive (EED).

  The Renewable Energy Directive. The RED focuses on promoting alternative energies to achieve emissions reductions, which simultaneously creates economic opportunities. The revisions to the RED would increase bloc-wide renewable energy use goals from 32% to 40% by 2030, and also set a benchmark of 49% renewable energy use by 2030 for energy in buildings. Seventy-five percent (75%) of the EU's GHG emissions come from energy use, making reductions in this area critical to the success of the EU's climate commitments.

  The Energy Efficiency Directive. The EED sets targets for overall improvements in energy efficiency, as well as a target for the rate for building renovations. Existing EED targets require, by 2030, a 32.5% improvement in overall energy efficiency and the renovation of 3% of all buildings (publicly owned and privately occupied). The proposals would increase the overall energy efficiency target to between 36 and 39% *and* add a 9% reduction of total energy demand, relative to a baseline scenario, by 2030. Significantly, the energy efficiency targets will be legally binding. Another element of this proposal is to require the public sector to renovate 3% of its buildings annually, intended "to drive the renovation wave, create jobs and bring down energy use and costs to the taxpayer."

- Improving the EU's carbon capture.

  The Plan also includes a proposal to revise the land use, land use change and forestry (LULUCF) regulation. The proposed amendment aims to strengthen commitments from the LULUCF sector, and combine non-CO2 GHG emissions from agriculture (e.g., fertilizer use and livestock) with the land use, land use change, and forestry sector. The result would be the creation of a newly regulated land sector that covers emissions and removals from agriculture, forestry, and other land uses.

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The proposal includes relatively minor (e.g., non-substantive) changes to the existing LULUCF regulatory framework initially (from 2021 to 2025), with the more substantive provisions and significant changes taking effect in 2026. Between 2026 and 2030, EU member states will be required to remove the equivalent of 310 million metric tons of CO2 emissions, with each state required to submit mitigation plans for the land sector. Beginning in 2031, non-CO2 emissions from the agriculture sector will be regulated, resulting in a regulation that covers the entire land sector framework for the first time in one instrument. Ultimately, the goal is for the European Union to achieve climate neutrality in the land use, forestry, and agriculture sectors by 2035.

The revised LULUCF regulation also would include a new system of governance to track compliance and non-compliance, along with enhancing monitoring requirements using digital technologies.

Next Steps

The legislative proposals included in Fit for 55 are intended to help the European Union achieve its goals of reducing GHG emissions 55% by the end of 2030 and becoming climate-neutral by 2050. However, the issuance of the proposals on July 14 merely kicked off a legislative process that will require consensus among the Commission, the European Parliament, and the EU Council, before the adoption of any new or revised requirements. Given the complexity of the proposals and the divergent views of different constituencies, it will likely be a lengthy process before negotiations are completed and a final set of proposals is adopted. Substantive changes also will undoubtedly be made to at least some of the proposals during the negotiation process. Potentially affected companies should continue to actively monitor further developments relating to the Fit for 55 proposals.

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