SQUIRE PATTON BOGGS

The Relationship Between the Energy Performance of Buildings Directive and the Extension of the Emissions Trading Scheme to the Buildings Sector

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Introduction

The European Union (EU) has set ambitious targets for the reduction of greenhouse gas (GHG) emissions to at least 60% in the building sector by 2030 compared to 2015, aiming at climate neutrality by 2050. The Energy Performance of Buildings Directive (EU/2024/1275, EPBD) together with the revised Energy Efficiency Directive (EU/2023/1791), and the application of the Emissions Trading Scheme (ETS), (introduced by amendments to the ETS Directive, Directive 2003/87/EC by Directive (EU) 2023/959) to the building sector are key to achieving these targets.

A separate ETS will be established for the building sector, road transport sectors and other industrial activities not covered by Annex I to Directive 2003/87/EC. This system will operate in parallel to the existing ETS for stationary installations and aviation to prevent disruption of its effective functioning, named EU ETS2.

This client alert looks at the relationship between the EPBD and the inclusion of the buildings sector in the ETS and explores how these policies interact to improve energy efficiency and reduce emissions. It analyses the synergies and potential conflicts between the two policies and provides recommendations for optimising their implementation.

Furthermore, the alert will examine how the EU plans to facilitate the integration of both measures: assigning a price to emissions generated in the building sector and the promotion of energy efficiency improvements. In this context, "facilitation" refers to the provision of additional funding sources to ensure that the new measures do not place an undue burden on vulnerable citizens. To this end, the EU has established the Social Climate Fund – an envelope of €65 billion to finance investments benefiting vulnerable households, micro-enterprises and transport users particularly affected by the EU ETS2.

Background

The buildings sector is one of the largest energy consumers and sources of GHG emissions in the EU, accounting for about 40% of total energy consumption and over 1/3 of GHG emissions. The EPBD aims to improve the energy performance of buildings, while the EU ETS is a cornerstone of the EU's policy to combat climate change by reducing industrial GHG emissions.

The EU ETS

In general, the ETS is a cap-and-trade system that sets a limit on the total amount of GHG emissions allowed from covered sectors, including power generation and industrial processes. Under the ETS scheme one allowance permits the holder to emit 1 ton of CO2 (tCO2). Under this scheme, a maximum (cap) is set on the total amount of greenhouse gases that can be emitted by all participating parties. Allowances for emissions are then auctioned off or allocated for free and can subsequently be traded. The companies must monitor and report their CO2 emissions, ensuring they hand in enough allowances to the authorities to cover their emissions. To exceed its emissions allowance, a company must purchase allowances from others. Conversely, if a company emits less than its allowance, it can sell its leftover credits. This allows the system to find the most cost-effective ways of reducing emissions without significant government intervention.

The ETS has been successful in reducing emissions from the power and industrial sectors, but it faces challenges such as:

- Volatile carbon prices
- The risk of carbon leakage (where companies relocate to regions with less stringent emissions restrictions)
- Integration with other policies and sectors.

Extension of the ETS Directive to the Buildings Sector

The extension of the ETS Directive to the buildings sector aims to provide a more comprehensive approach to emissions reduction by including all major sources of emissions into the ETS scheme.

Interestingly, due to the very large number of small emitters in the building sector (such as homeowners and tenants), as specified by recital 77 of Directive (EU) 2023/959, it is not feasible to identify the entities directly emitting GHG, as is possible for stationary installations, aviation and maritime transport. Therefore, for reasons of technical feasibility and administrative efficiency, Directive (EU) 2023/959 establishes that the act triggering the compliance obligation under the new ETS2 is the release for consumption of fuels used for combustion in buildings. Consequently, the entities obliged to surrender allowances under the EU ETS2 mechanism will be the regulated entities defined in accordance with the system of excise duty established by Council Directive (EU) 2020/262, while final consumers of fuels in these sectors will not be subject to obligations under Directive 2003/87/EC.

"Regulated entities" are those engaged in activities referred to in Annex III of the EU ETS Directive, which includes the release for consumption of fuels used for combustion in buildings and that fall under specific categories specified therein, such as authorised warehouse keepers. Even though these regulated entities will bear the economic burden of the new system introduced, it is reasonable to assume that they will sell these fuels to national energy providers at a higher price that reflects the increased costs from the obligation to purchase allowances. This is likely to result in higher prices for fuel purchases and consequently higher bills for consumers.

To reduce this consumer related burden, the introduction of the carbon price in the building sector will be accompanied by effective social compensation, particularly considering the existing levels of energy poverty — as will be further specified in the section of this alert dedicated to the Social Climate Fund.

The EPBD

Since its implementation, the EPBD has led to significant progress in the energy efficiency of buildings. However, challenges remain, including:

- Ensuring compliance in all EU Member States,
- Dealing with the diverse building stock in the EU
- Financing energy efficiency renovations

The revision of the EPBD aims to promote improvements in the energy performance of residential and commercial buildings. Key provisions include:

- The gradual introduction of minimum energy performance standards for non-residential buildings based on national thresholds to trigger the renovation of buildings with the lowest energy performance
- A binding target to decrease the average energy performance of the national residential building stock by 16% by 2030 in comparison to 2020, and by 20-22% by 2035, based on national trajectories
- An enhanced standard for new buildings to be zero-emission and the calculation of whole life-cycle carbon for new buildings
- Enhanced long-term renovation strategies, to be renamed national Building Renovation Plans
- Increased reliability, quality and digitalisation of energy performance certificates with energy performance classes to be based on common criteria
- The introduction of building renovation passports to guide building owners in their staged and deep energy renovations
- Increased deployment of solar technologies on all new buildings and certain existing non-residential buildings where technically and economically feasible, and ensuring that new buildings are solar-ready (fit to host solar installations)
- A gradual phase-out of boilers powered by fossil fuels, starting with the end of subsidies to stand-alone boilers powered by fossil fuels from 1 January 2025
- One-stop-shops for the energy renovations of buildings for homeowners, small and medium-sized enterprises and other stakeholders
- Further roll-out of recharging points for electric vehicles in buildings, removing barriers to their installation, enabling smart charging and introducing measures for bike parking in buildings
- Data collection and sharing, to improve knowledge on the building stock and awareness on energy consumption in buildings.

Among the provisions listed above, particular emphasis is placed on those expected to have a significant impact. First, each EU Member State is required to adopt a national plan aiming to reduce the average primary energy use of residential buildings by 16% by 2030 and by 20-22% by 2035. Second, EU Member States must renovate the 16% worst-performing non-residential buildings (representing 43% of buildings with the lowest energy performance nationwide) by 2030 and the 26% worst-performing buildings by 2033.

Third, the law mandates that all new residential and non-residential buildings achieve zero on-site emissions from fossil fuels. This requirement starts on 1 January 2028 for publicly owned buildings and on 1 January 2030 for all other new buildings, with specific exemptions permitted.

The process of adopting this legislation was highly contentious, resulting in a final text that is less ambitious than originally proposed. Nonetheless, it is expected to significantly enhance the energy performance of buildings across Europe. While this will entail substantial costs for citizens, it will yield long-term benefits by reducing energy consumption and, consequently, energy bills.

Furthermore, the EPBD specifies that EU Member States should allocate various funding sources to support these interventions, aiming to maximise the cost-effectiveness of national and Union-level financing. This includes leveraging resources from the Social Climate Fund and revenues generated by ETS2 auctions.

The Social Climate Fund

The Social Climate Fund (SCF) will provide EU Member States with significant financial support from 2026 to 2032, with a total of €65 billion available. The fund will be financed through the revenue from auctioning of allowances in the EU ETS and ETS2. The three largest beneficiaries of SCF will be Poland with more than €11 billion available as well as, France, and Italy, each eligible for receiving over €7 billion.

To access the funds, EU Member States will have to submit their national Social Climate Plans to the EU Commission, which must include measures and investments to:

- Carry out building renovation, and decarbonise heating and cooling of buildings, including the integration of renewable energy generation and storage
- Increase the uptake of zero- and low-emission mobility and transport

These instruments should primarily benefit vulnerable households, micro-enterprises and transport users. In exceptional cases, other actors may benefit if their measures and investments ultimately benefit the vulnerable groups.

Each plan will have to be previously consulted with relevant stakeholders such as economic and social partners or civil society organisations.

Synergies Between the EPBD and the ETS2

Both the EPBD and the ETS2 aim to reduce GHG emissions and improve energy efficiency. The EPBD provides the basis for high energy performance in buildings, which can be further incentivised by the financial mechanisms of the ETS2. Together, they create a dual approach by using both the regulatory standards (EPBD) and market-based incentives (ETS2).

An integrated policy framework can enhance the effectiveness of both the EPBD and the ETS2:

- By ensuring that energy performance improvements result in emission reductions
- By aligning financial incentives with regulatory requirements
- Providing a coherent strategy for achieving the EU's climate change objectives

Outlook

The EU ETS2 will become operational from 2027 earliest, while high energy prices later this decade may even postpone the start until 2028. Not all details have been finalized so far, especially as EU Member States are allowed to exempt fuel suppliers from the ETS2 in case a national carbon price scheme with a price level equivalent or higher than the existing EU system. The Innovation Fund funded by ETS will provide around €38 billion of support from 2020 to 2030 (at €75/tCO2), depending on the carbon price, for the commercial demonstration of innovative low-carbon technologies, aiming to bring to the market industrial solutions to decarbonise Europe and support its transition to climate neutrality. Further, the Innovation Fund, currently sourced from 450 million allowances from the existing ETS in 2021-30, would be topped up with around 125 million allowances from EU ETS 2. Therefore, the allocation of funding of the amount of the Innovation Fund from ETS, will be stocked up from 450 million ETS allowances to 575 million ETS allowances. At a higher average price of €90/ton this represents a monetary value of more than €50 billion to be allocated to decarbonisation projects. In addition, earnings of EU Member States from auction income must now be entirely used for climate measures.

One of the largest concerns of the European Parliament was that the introduction of the EU ETS2 will predominantly hurt economically weaker states and citizens. Therefore, the current agreement allocates 50% of the income from the ETS to the newly introduced Social Climate Fund. It should support vulnerable households and small businesses to cope with the price increase of fuels. The fund would start operation in 2026, one year before the actual pricing scheme commences, and is set up to run until 2032 for now. As mentioned, it is supposed to have a budget of about €65 billion for social climate measures such as renovation in social housing to direct income support. The remaining 50% of the income passes to the EU member states, which must use the money for social climate measures in the building and transport sector as well. An estimated total of €87 billion will thus be allocated to reduce social hardships due to more comprehensive carbon pricing. This sounds like a huge amount of money but it has to be seen in relation to other expenses to alleviate the current fossil energy price crisis which might more than €100 billion in some EU Member States.

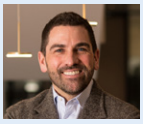
How We Can Help

In this phase, our law firm can assist in various aspects:

- We can assist regulated entities in understanding and complying with the new regulations, including facilitating the purchase of allowances where necessary
- We can help stakeholders in the construction sector navigate available incentives to secure financial support for implementing energy efficiency improvements
- We can monitor consultation on the national Social Climate Plans in the most benefiting countries – Poland, France and Italy and prepare strategies for national and EU level advocacy efforts

Our team of experts includes attorneys practicing across all major European jurisdictions, complemented by our Brussels-based team specialising in European regulatory law.

Contacts



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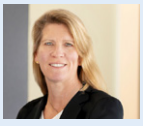

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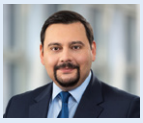

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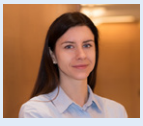

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