EU's Fit-for-55 to Spur Energy Transition in Multiple Sectors

Lead Time Softens, but Does Not Eliminate, Regulatory Pressures

- Changes to the EU ETS are among the most notable proposals in the 'Fit-for-55' package
- New costs will affect profitability across sectors due to compliance with increasingly stringent emissions quotas; many industries will incur higher capex for carbon reduction
- The proposals are subject to debate and amendments by member states; the most significant ones are scheduled to come into force in the latter half of this decade
- European aviation, shipping, automotive, utilities, and many extractive industries will be among the most affected in the long term, if proposals are enacted

The EU has released a wide-ranging set of inter-related regulatory proposals to reduce greenhouse gas (GHG) emissions by 55% (compared to 1990 levels) by 2030. The package, 'Fit-for-55', will increase regulatory pressure, as well as costs, related to emissions from domestic production and imports into the EU. These will affect companies across a wide spectrum of industries.

Fitch Ratings considers regulatory shifts a crucial factor that can influence credit risks and ratings. Predictable regulatory changes communicated well in advance typically lessen the potential impact as issuers have time to prepare to comply.

We expect the implementation lead time for the EU's 'Fit-for-55' proposals, and the reasonable clarity around longer-term tightening of emission standards, to reduce the risk it may present for issuers.

Compliance Costs, Investments to Rise

Even so, pressure on issuers' profitability in most affected sectors will increase, particularly where new costs cannot be passed on further down the value chain and distributed more widely due to competitive or pricing dynamics. The investments needed to decarbonise and to comply with the new requirements will also increase, negatively affecting issuers' cash flows.

One of the most wide-ranging sets of proposals expands the EU's European Emissions Trading Scheme (ETS) to include new sectors, such as shipping. It also includes the set-up of a brand new ETS scheme for road transport and building fuels to be complied with by fuel providers. Furthermore, the proposals anticipate the reduction of the overall number of permits available and taper down free allowances from 2026 onwards.

The proposal to introduce the Carbon Border Adjustment Mechanism (CBAM) will mirror the carbon costs of domestic producers for importers into the EU in hard-to-abate polluting sectors – steel, cement, aluminium, electricity and fertilisers.

If proposals pass in their current or near-current form, which at this point is far from certain, we expect European carbon prices to increase.

Changes to Business Profiles Accelerate

Proposed measures will be gradually phased in, with those that are most challenging for issuers coming into force towards the latter half of this decade – beyond our forecast horizon. Such measures include a reduction in the supply of permits when demand increases, and payments by importers under the CBAM. Both measures will increase operating costs of affected industries.

However, we expect most issuers to fast-track efforts to adjust their business profiles, enabling them to face the accelerating energy transition more easily. This could mean increased capex, potential disposals of their most-polluting operations, and acquisitions of more sustainable businesses or stranded assets write-downs.

We will continue to assess the impact of such strategies on issuers' credit profiles on a case-by-case basis.

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ETS Expansion Is Package's Focal Point

The EU ETS is a central mechanism in the EU's emissions reduction arsenal and the most mature cap-and-trade scheme of its kind. The EU Commission has made the expansion of the ETS a focal point of its 'Fit-for-55' package. This will have the most direct credit implications for issuers, with those in sectors with higher cost bases or hard-to-abate emissions seeing most of the impact, especially as new regulation will spur further carbon price increases. The Commission anticipates a carbon price of around EUR85/tonne by 2030 in response to the proposals.

ETS Allowance Costs

The cost of allowances in the ETS has reached its highest levels since market intervention in 2018 to address oversupply.

- An increase in coal-to-gas fuel switching has been the major consequence of this, and many utilities have opted to hedge against future price increases or "bank" allowances in anticipation of rising prices and potential profits.
- By contrast, large industrial producers have typically taken a more reactive approach to ETS compliance - spurred by free emissions allocations – finding current prices insufficient to justify the more substantial capital investments needed to significantly lower emissions.

This points to some of the wider challenges facing regulators in using emissions trading as a tool to deliver emissions reductions.

Carbon emission abatement costs vary hugely across sectors, so compliance costs are likely to differ sharply. The Independent Commodity Intelligence Services estimate that prices in excess of EUR200/tonne could be necessary in the buildings and transport sector to incentivise reductions given the complexity and cost of decarbonising assets in those sectors.

With the proposed addition of the shipping sector to the ETS, and phased removal of free allocations for aviation by 2026, demand for emissions allowances is likely to rise sharply, leading to further upwards pressure on the price of carbon and relatively high compliance costs in these hard-to-abate sectors, which typically have long capital investment and asset lifecycles – and therefore have long payback times for investments.

More Sectors, Fewer Free Allocations

The Commission plans to include road transport fuels, shipping, and buildings fuel emissions in the ETS. Tapering down free allowances for aviation is also a key element of the ETS expansion. All these sectors are hard-to-abate, with the least exposure so far to external emission regulatory interventions.

Airline and Shipping Fuels in Focus

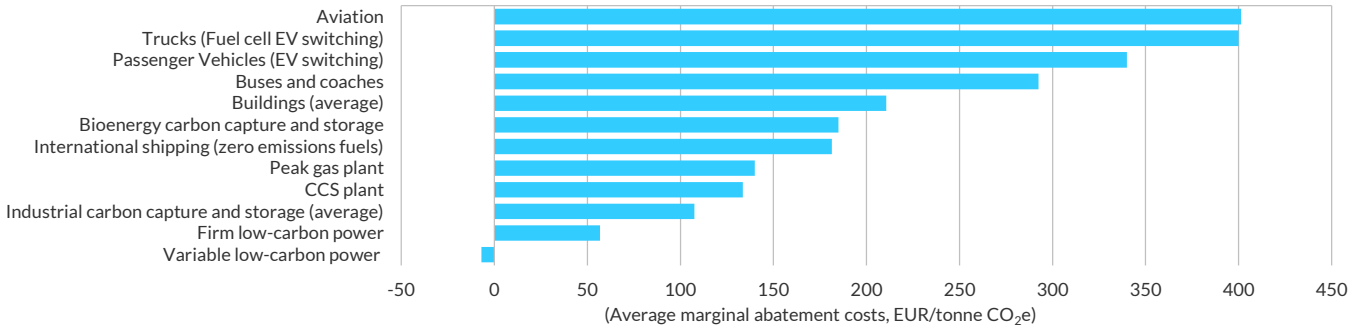
For aviation, the proposal is to continue to apply EU ETS for intra-EEA flights and implement the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) on other international flights. It also proposes to remove free allowances for emissions from intra-EEA travel by 2026 and to initiate fuel surcharges for jet fuels for intra-EU flights (excluding cargo-only flights), which will rise incrementally each year over a ten-year period to reach a minimum of EUR10.75 per gigajoule (GJ). This is likely to lead to significant additional costs over time that may need to be passed through to consumers in higher ticket prices.

Shipping will be included in the EU ETS for the first time from 2023 with a three-year phase in, with all intra-EU emissions and emissions from half of the trips outside of EU ports captured. Minimum rates of taxation on bunker fuels are also proposed under revisions to the Energy Taxation Directive.

The aviation and shipping sectors have initiated efforts of self-regulation around emissions through CORSIA and the IMO Initial GHG Strategy, respectively. European flights have been subject to the EU ETS since 2012, but the majority of permits are allocated for free. The new changes are the first time the EU has proposed to enact an EU-wide regulation for both internal and external routes (through participation in CORSIA for all EU member states) and for direct pricing of emissions in shipping.

Regulations for more sustainable aviation and maritime fuels, through FuelEU Maritime and ReFuelEU Aviation, with mandates for fuel suppliers to increase supply and blending of sustainable fuels incrementally to 2050 are also proposed. These fuels are currently not available at large scale and are traded at a premium.

Abatement Costs Differ Significantly by Sector, Activity



Note: The above chart shows the average marginal cost of delivering a tonne of CO_2-equivalent emissions reductions in each sector, across a range of existing technology options and capital or operational investment activities. In practice, some required activities may incur lower costs (for example offsetting emissions, energy efficiency measures) or higher costs (such as replacement of existing assets, addition of ground source heat pumps in buildings). Lower-cost options are likely to be used initially for incremental reductions, but more costly measures are likely to be needed to deliver deeper emissions cuts and alignment with the Paris Agreement pledges. The figures presented here represent an average of these total costs divided by the total emissions reductions required.
Source: Fitch Ratings, Frontier Economics, Committee on Climate Change, Hasan, et al (2021), Teagasc, Wood Group, IPCC, Global CCS Institute, Johnsson et al (2020)

While the concurrent introduction of a tax on jet fuels and bunker could reduce the cost difference, unless these costs decrease and more volumes are made available, the net cost of fuels will increase.

Europe-focused carriers could be particularly affected because the EU ETS is a stricter measure than the CORSIA. CORSIA has a more recent base year for free allowances and does not cap total emissions but allows airlines to simply 'offset' if they exceed the limit. Fitch expects airline traffic levels in Europe will be slower to return than it had originally expected. There will be structural shifts post-pandemic, and lower business travel may cause the permanent loss of a portion of demand.

Costly Renovations a Means to Reduce Rising Fuel Costs for Buildings

The Commission notes that buildings consume 40% of energy used in the EU and generate around 36% of energy-related emissions. Inclusion in a new ETS is proposed to work by regulating the suppliers of fuels to buildings (natural gas and fuel oil/diesel) beginning in 2026. The Commission also estimates that 75% of the building stock in Europe is energy-inefficient and the remaining 25% is largely residential properties constructed since 2011, under stricter building standards.

Assuming the industry is able to pass these costs on to consumers, the costs to owners, tenants and residents will likely increase, boosting demand for newer, more energy-efficient properties and concurrently potentially steepening discounts in rental and market values for older or less energy-efficient buildings.

The Energy Efficiency and Renewable Energy Directives have set targets for energy-efficiency improvements, such as an aim to renovate at least 3% of the total floor area of buildings owned by all levels of public administration each year. A higher share of renewable energy use in buildings could mitigate some of the costs of the new ETS for buildings, but this only seems likely after expensive "deep" renovations have taken place on older stock.

However, existing initiatives are insufficient to significantly boost the supply of energy-efficient mortgages to finance the acquisition, construction or renovation of properties serving as collateral for green residential and commercial mortgage-backed securities and covered bonds, adding to pressure.

Power Sector's Wealth of Decarbonisation Experience

The power sector in Europe, the first to be included in the EU ETS, has had years to adapt to the costs associated with higher carbon emissions. The recent ramp-up in carbon prices presents some challenges; future carbon price gains, if they materialise, will accentuate these.

Utilities and power generators that are pivoting their fuel mix towards renewables could benefit from the shift to a low-carbon energy mix as it could aid their profitability.

The 'Fit for 55' package does not change much for the power sector, but accelerates some of the current trends. The Commission is proposing to increase the target of renewables in the EU's energy mix to 40% from 32% by 2030, to take hydrogen into account in the mix of energy used in transport and industries, and to set up the mandatory issuance of guarantees of origin for renewable electricity to improve traceability.

The new renewable energy target, and the ramp-up in the production of green hydrogen, would require faster wind and solar development and large investments in these technologies.

While the economics of the wide-scale use of blue or green hydrogen remain challenging, an increasing share of financing from the EU and other sources is being directed towards increasing hydrogen use and availability of supply. This is in line with the EU's Hydrogen Strategy, which sets a target of establishing 40GW of electrolyser capacity by 2030 in the bloc.

Finally, the guarantees of origin could accelerate the growth of corporate PPAs in Europe, which would help to support the long-term revenue visibility for utilities given decreasing regulatory incentives and increasing investment.

CBAM to Create a Level Playing Field for Domestic Producers and Importers

Closely related to the proposals of the EU ETS revisions is the proposal on the Carbon Border Adjustment Mechanism (CBAM). This is effectively an import levy on steel, cement, fertilisers, aluminium and electricity generation from outside the EU with the aim of reducing carbon leakage as free carbon permits in the EU for these sectors are tapered over 2026–2035.

We expect this initiative to be a sensitive one for the EU as it faces opposition by major importers, notably China and the US. If such a charge were to come into force, major exporters of raw materials and industrial products from Russia, Turkey and Ukraine would have their costs increased. However, the production costs of many Fitch-rated exporters are fairly low, allowing them to absorb the new levy while remaining competitive in European markets. Cost pressures will be limited in the medium term as actual payments under the CBAM should start from 2026.

Nonetheless, the focus of the CBAM on Scope 1 emissions only means that impacts are likely to be higher on the commodity sectors where the bulk of emissions are in direct operations (such as blast furnace steel, ammonia fertilisers or cement) than Scope 2 emissions from purchased electricity (such as aluminium or electric arc furnace steel). Crucially, whilst compensation for Scope 1 emissions costs under the ETS is intended to be phased out from 2026, compensation for Scope 2 emissions is expected to remain in place.

The extent to which the EU ETS can ultimately apply to more sectors is dependent on the fate of the CBAM. If it were to be watered down or not implemented at all, then the scope for much stricter EU ETS envelopes and tapering of free permits would be undermined as the costs to EU industrial competitiveness would soar; by itself an economically and politically unpalatable decision for the EU member states.

Emissions Targets Put a Timer on European ICE Sales

The proposal for regulations on passenger car and van CO_2 emissions is a de facto ban on new passenger cars sales with internal combustion engines (ICEs) from 2035, with a zero emissions target from new cars and vans.

CO_2 Reduction Targets for Cars and Vans

	Cars		Vans	
(%)	Old	New	Old	New
2025	15	15	15	15
2030	37.5	55	31	50
2035	n.a.	100	n.a.	100

n.a. – not applicable
Source: Fitch Ratings, European Commission

We have been anticipating an increase in regulatory pressure on the European autos sector and believe that it will be a regulatory push that propels the EU electric vehicle (EV) market forward.

However, a synchronised expansion of charging networks and ongoing policy support, including purchase subsidies, will be crucial for the market to reach critical mass. The proposal to upgrade the Alternative Fuels Infrastructure Directive to regulation seeks to ensure that member states have strict mandatory targets on deploying public charging infrastructure as the ICE emissions become stricter.

If these proposals pass in near to their current form, pressures on European automakers' profitability will further increase due to the EV roll outs. We cite GHG emissions regulations as a rating driver for our European carmakers, reflected in an ESG Relevance Score of '4' for GHG Emissions.

European Automakers' ESG Relevance Score for "GHG Emissions & Air Quality" (EAQ) Risk Issue

Issuer	LT IDR/Outlook	EAQ score
Volkswagen AG	BBB+/Positive	4
Renault SA	BB/Negative	4
Daimler AG	BBB+/Positive	4
Stellantis N.V.	BBB-/Stable	4

Note: ESG Relevance Scores are on a scale from '1' to '5', with '1' representing no relevance to ratings and '5' representing high relevance to ratings and a key rating driver. EAQ is one of the five risk issues that make up the environmental score of ESG.RS
European automakers have the highest score of '4' in the peer group with all other global manufacturers having an EAQ score of '3'
Source: Fitch Ratings

Pressure on member states to expand the charging network shifts some of the investment burden away from manufacturers, and the lead time for these changes relieves some pressure from carmakers, enabling them to scale up EV production and enhance profitability, as many are likely to do in the next two years or so. Nonetheless, the de facto ban of ICE sales in Europe in less than 15 years significantly shortens the timeline for automakers to scale up production and profitability of other alternative fuel vehicles.

Energy Sectors to See Changes in Consumption

The proposals will shift demand patterns in the oil and gas and petrochemicals sectors, as autos are responsible for about 25% of oil demand in Europe. The sectors will be further affected by changes in airline and shipping fuel regulations. Under the UN FPS scenario oil demand will peak in the late 2020s and start falling steadily thereafter.

Compulsory mandates for sustainable aviation fuels adds pressure for investment, innovation and higher production for these fuels from jet fuel producers, while the new ETS for road transport and building fuels will create new compliance costs for fuel marketing operations.

Most oil and gas and petrochemical companies are preparing for the energy transition and decarbonising their operations. All European majors are planning to partially substitute oil with alternative energy sources in the next few years with some of them expanding natural gas and LNG production as a "bridge" energy source, transforming existing refineries into biofuel sites, and boosting green hydrogen production.

Amendments Certain, Scope Uncertain

At the moment these regulatory proposals from the European Commission are just that – proposals. Months, perhaps even years for some elements, of negotiations between the Commission, the EU Parliament, and the European Council are due before they are put into legislation. Member states have differing objectives and priorities, and the extent to which they are willing to accept a heavier regulatory regime governing a plethora of vital economic sectors will vary hugely, driving revisions to the proposals.

We view the start of the process as evidence that the climate change-related regulatory burden on European issuers will increase, driven by the EU's ambitions to lead on global emission-reduction efforts. In some key sectors, such as autos, the new proposals represent a substantial tightening of regulation beyond previous ambitions, which will impose additional compliance costs.

These developments are aligned with the wider EU Green Deal objective of making Europe's GHG emissions neutral by 2050. They are also associated with actions on the financial and capital markets mechanisms, including the EU Taxonomy, which seek to direct capital to industries and sectors that will achieve carbon neutrality by 2050.

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