MAKING THE ETS 2 AND SOCIAL CLIMATE FUND WORK

GUIDANCE FOR NATIONAL POLICYMAKERS

POLICY BRIEF

NOVEMBER 2023

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KEY MESSAGES

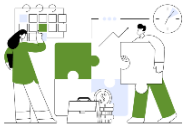
The framework of the ETS 2, together with its obligations for revenue recycling and the specific role of the Social Climate Fund, follows current international good practice.

- On its own, the carbon price may exacerbate energy and transport poverty. Hence the need for the Social Climate Fund and other revenue use.
- Impacts are different in each Member State, so the response strategies should be tailored.
- A key objective is to empower vulnerable groups to reduce their dependence on fossil fuels.

For the Social Climate Fund to be a success, it must be implemented well. Each Member State now needs to develop a national Social Climate Plan. This challenge has three key steps:

STEP 1. ASSESS NATIONAL VULNERABILITY PATTERNS

- Select and define a set of vulnerability indicators
- Use already available national-level data
- Work to improve data sources and indicators



STEP 2. DESIGN A SET OF POLICY MEASURES

- Integrate local-level data, indicators, and delivery channels
- Start simple and improve accuracy over time
- Build on good-practice examples
- Take a holistic approach to policy design

STEP 3. STAKEHOLDER ENGAGEMENT

- Stakeholder consultation should start early
- Actively engage municipalities
- Hold regular meetings with stakeholders
- Develop a communication strategy

INTRODUCTION

Europe's new carbon pricing mechanism, the ETS 2, was passed in early 2023 as a tool to foster the low-carbon transition and meet ambitious climate targets in the buildings and road transport sectors. These two sectors together are responsible for 32% of the EU's total GHG emissions[1], which have so far proven difficult and slow to abate. Within the framework of the European Green Deal, the new system now aims to increase and harmonise economic incentives, to give more certainty to emission reductions in these sectors, and thereby support Member States in reaching their national climate targets.

At the same time, the carbon price incentive on its own cannot be fully effective. Decarbonising these sectors requires long term investments in energy efficiency, renewable energy, and alternative forms of zero- and low-carbon transport. Not all households are in the position to react to the carbon price, and there is a risk that vulnerable sections of European society will be negatively and unfairly burdened by rising energy costs. Targeted investment opportunities and supporting policies are required to make the carbon price work as intended so that no one is left behind. This is precisely why the ETS 2 is being paired with the Social Climate Fund (SCF), a mechanism to collect and channel revenues to support those who need it.[2]

> The framework of the ETS 2, together with its obligations for revenue recycling and the specific role of the Social Climate Fund, follows current international good practice in carbon pricing policy. Implemented well, they represent a comprehensive approach to foster an inclusive, society-wide, low-carbon transition.

The ETS 2 is set to cover emissions from fossil fuels used in buildings, road transport, and some additional industrial activities. The carbon price will fall first on the distributors of coal, natural gas, heating oil, gasoline, and diesel, who are expected to pass on most of their compliance costs to consumers by raising fuel prices. Starting from 2027[3], a uniform carbon price will be felt by consumers across Europe. While the policy aims at a carbon price of €45 per tonne, there is no fixed price ceiling, so prices may go substantially higher. This underlines the importance of investing early in emissions reductions and preparing to support the most vulnerable. To this end, the Social Climate Fund will start in 2026, one year before the carbon price comes into effect.

[1] The road transport sector (excluding aviation and shipping) was responsible for 20% of EU total GHG emissions, and buildings (residential and commercial) for 12% in 2018.

[2] The Social Climate Fund is established to help finance 'measures and investments' that shall benefit households, micro-enterprises, and transport users who are 'vulnerable and particularly affected' by the ETS 2, in particular those in energy and transport poverty (Article 1 of Regulation (EU) 2023/955).

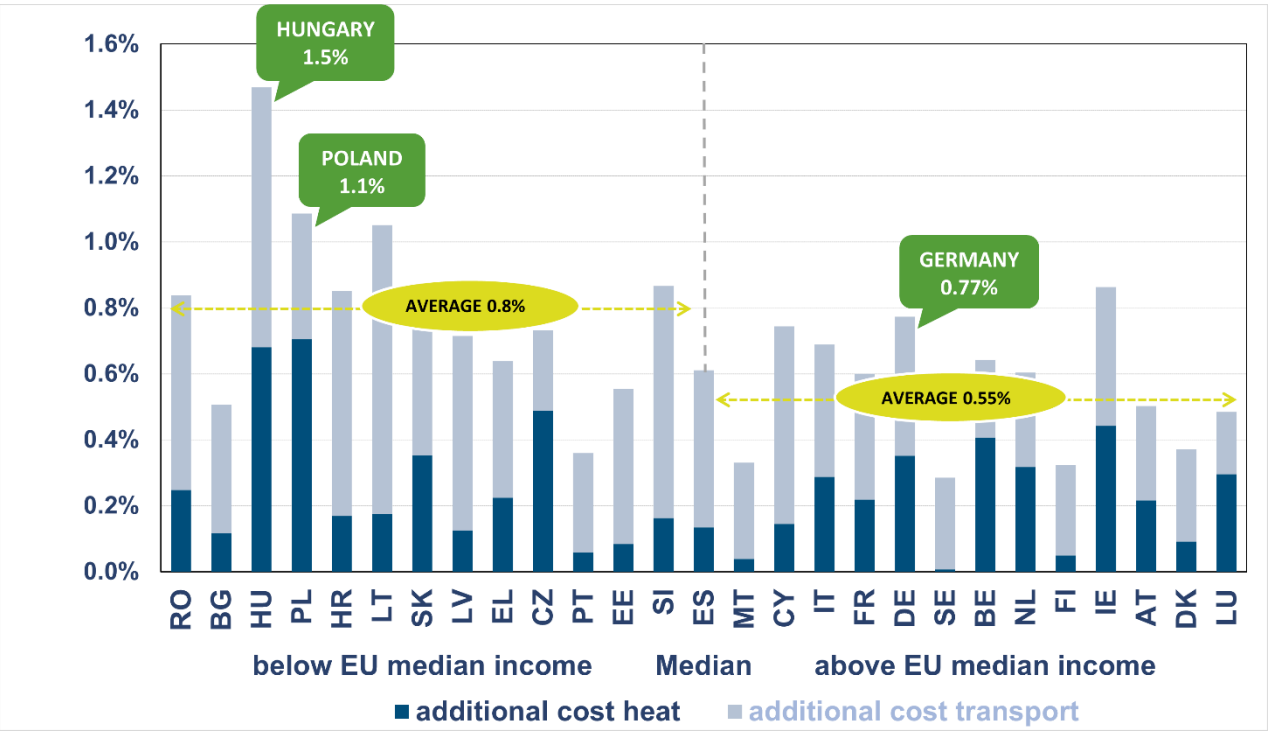
[3] There is a possibility to delay start of the system for one more year in case gas and oil wholesale prices are exceptionally high compared to historical trends.

I. MEMBER STATES FACE BOTH IMPACTS AND OPPORTUNITIES

The carbon price may exacerbate energy and transport poverty. On its own, the ETS 2 carbon price will likely be regressive – it will disproportionately burden lower-income households who spend a larger share of their income on fossil fuels and lack the means to adapt by switching to less carbon-intensive alternatives. Households living in energy or transport poverty are particularly vulnerable, as are poorer households with no option but to depend on fossil fuels for their basic needs, such as those in remote rural areas. More than 35 million EU citizens already experience energy poverty. Without action to compensate the impacts of the carbon price, the situation could worsen, further risking a popular backlash against the policy.

The burden of ETS 2 costs differs across Member States, so the response strategies will differ. The carbon price becomes burdensome, the higher the share of the household budget that needs to be spent on rising energy and transport costs. On average across Europe, an ETS 2 carbon price of around €70 will have a limited impact on household expenditures (Figure 1).

Figure 1. Average increase in household expenditures (as % of total) due to an ETS 2 carbon price of €70/tCO2



Yet, regressive effects are present both at the level of households and countries. While all Member States are home to some vulnerable populations, the cost burden will be greater in lower-income Member States, particularly those in the CEE region. Socio-economic conditions, shaped by historical and structural factors, mean that every country will experience the carbon price in their own unique socio-economic context. The policy response therefore needs to be driven by Member States and tailored to national circumstances.

The ETS 2 revenues will provide financing for Member States to address social impacts and foster decarbonization. The ETS 2 will generate significant revenues through the full auctioning of emission allowances (see Figure 2). The main share of revenues will go directly to Member States and may be used at their discretion for broad-based climate and social measures. Around a third of the revenues (including the Member States' own contributions), will be channelled through the Social Climate Fund, with clear rules defining the types of measures and target groups that may be funded. Based on the principles of fairness and solidarity, the Social Climate Fund will be allocated to Member States via a progressive formula, so lower-income countries with greater rates of energy poverty will get more. It is now in the hands of national policymakers to develop a response strategy that utilizes the available ETS 2 revenue streams.

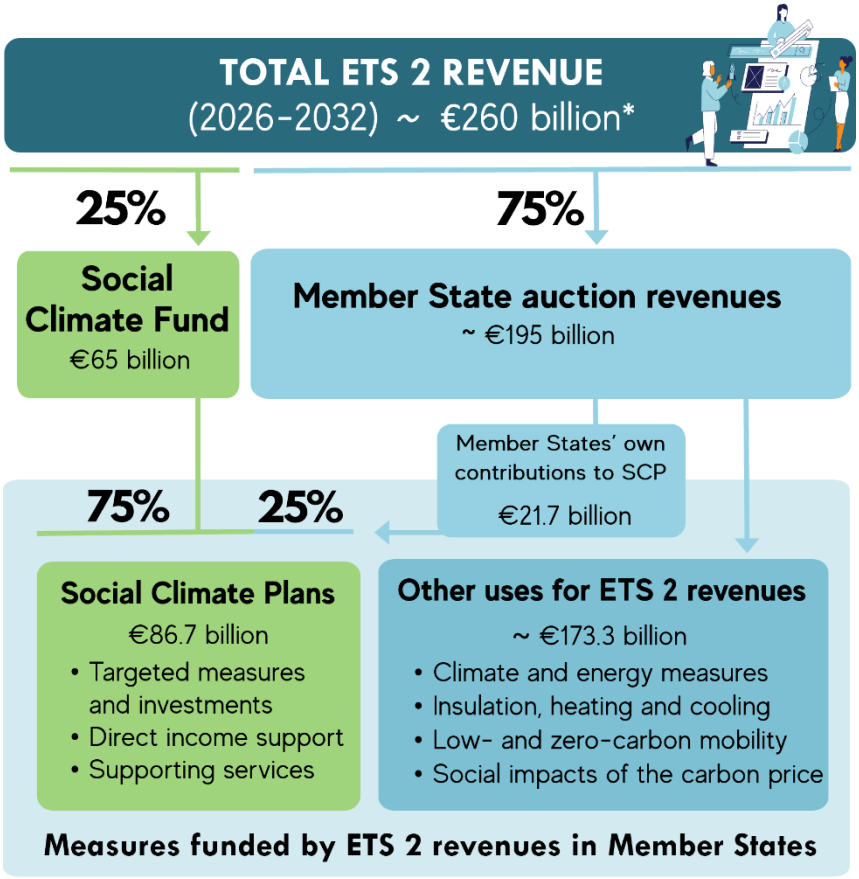


Figure 2. Estimated ETS 2 revenues (based on a carbon price of €45/t)

A key objective of the Social Climate Fund is to empower vulnerable groups to reduce their dependence on fossil fuels. This should be done by funding green investments that address the fundamental causes of energy and transport poverty. Until such investments take effect, around a third of the funds may also be used to provide temporary direct income support. Furthermore, all measures must be targeted at vulnerable groups, ensuring a share of ETS 2 revenues will directly support those vulnerable to its impacts.

The Social Climate Fund represents an additional policy tool in the fight against energy and transport poverty. The green investments under the SCF have the potential to reduce fossil fuel reliance and their associated costs. In this respect, channelling the proceeds of the carbon price back to society has the potential to do more than just correct the regressive effects of the carbon price, but also help Europe to deal with some of its most persistent and pressing social challenges.

II. EACH MEMBER STATE NEEDS TO DEVELOP A SOCIAL CLIMATE PLAN

For the Social Climate Fund to be a success, it must be well implemented. Each Member State now needs to develop a **national Social Climate Plan** that details how they intend to identify vulnerable groups and provide them with the support needed. National Social Climate Plans will serve as basis for allocating funding. They are to be developed by Member States and submitted to the European Commission by 30 June 2025 for revision and approval. The SCF Regulation outlines in detail the requirements for Social Climate Plans and provides a template to guide Member States through the process[4]. Here below is a summary of some of the key components of the plans, which deal with how to identify impacts and vulnerability patterns, design and implement policies, and engage with stakeholders and other partners in the process.

The information to be included into Social Climate Plans:

- An **assessment of the effect of the ETS 2 carbon price on households** and how it will likely affect levels of energy and transport poverty across different areas.
- The estimated **number of vulnerable households and transport users**, including information on how vulnerable groups are identified and how the SCF definitions of energy and transport poverty are applied.
- **A coherent set of new and existing national measures and investments with lasting impacts,** as well as explanations of how these green investments should help meet the objectives of the policy.
- **Eligibility criteria for granting direct income support**, as well as time limits for such support, its justification, and an explanation of how this measure should address energy and transport poverty.
- **The estimated costs of the plan's implementation**, including the country's own contribution.
- **Targets, milestones, and an indicative timetable** for implementing measures, together with arrangements for their effective monitoring.
- **A summary of public consultations** and details of how stakeholder input is considered in the preparation and implementation of the Plan.

National agencies need to work together with experts and stakeholders to complete a range of analyses, assessments, and consultations. The short timeframe and the scope of work required to prepare and implement Social Climate Plans therefore presents a considerable challenge. This challenge can be broken into **three key steps** – identifying vulnerability patterns, designing measures, and engaging with stakeholders. Each task depends on the other for success, yet the work needs to happen in parallel, so all three processes should begin as soon as possible.

[4] See Annex V to the Regulation (EU) 2023/955

STEP 1. ASSESSMENT OF NATIONAL VULNERABILITY PATTERNS

Firstly, it is important to understand who is vulnerable and why. The scope and objectives of the SCF are focused on addressing the direct social impacts of the ETS 2 carbon price, so funding should primarily target the vulnerable, being those that already experience energy poverty or transport poverty, as well as low-income households that are significantly affected by the carbon price and lack the means to adapt.

This means the first step in preparing Social Climate Plans is to **identify patterns of vulnerability to the ETS 2 carbon price and uncover the factors that are causing it.** A range of indicators can be used to measure energy and transport poverty, using household data on income, expenditures, and location. By selecting appropriate indicators and using existing datasets, analyses can already begin to explore patterns of energy and transport poverty within each country.

Key considerations and challenges:

There is no "one-size-fits-all" indicator capturing all dimensions of vulnerability in all Member States. Rather, there is a range of possible indicators, each considering a different aspect of vulnerability by measuring a household's energy expenditure and income level, or by assessing their ability to heat the home and pay their bills. And while the SCF Regulation provides definitions, it does not determine which indicators to use, so it is up to Member States to decide how best to measure and monitor vulnerability. To make things more complicated, data is often inconsistent or missing, and some standard indicators (such as for transport poverty) are yet to be developed.

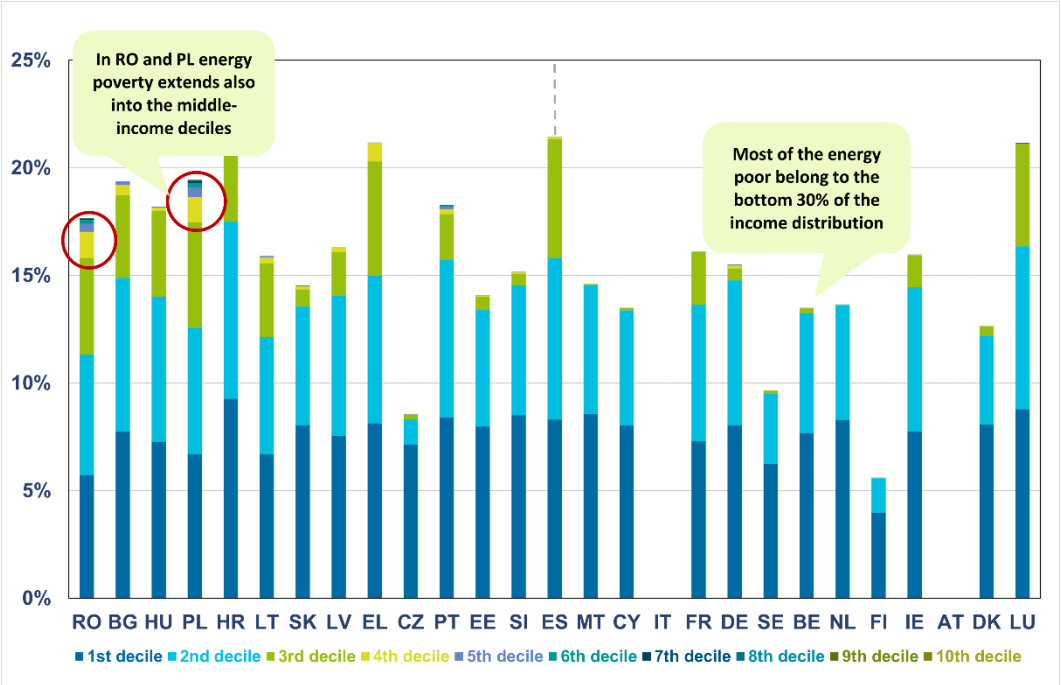


Figure 3. The relationship between vulnerability and income in EU MS for the share of the population identified as 'energy poor' according to the LIHC indicator for heating and electricity costs.

The country-specific context influences patterns of energy and transport poverty. Across Europe, using the low-income-high-cost indicator, it is typically the poorest 30% that are vulnerable. Yet in several countries, such as Poland and Romania, vulnerability also extends to middle-income households (see Figure 3). The urban-rural divide also plays a role - households in the countryside are more likely to be vulnerable in lower-income countries, while the pattern is typically reversed in higher-income countries. Although a few common trends can be discerned, country-specific analyses are needed to dig into the national context and find the underlying causes of vulnerability.

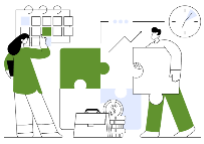
OUR RECOMMENDATIONS:

Select and define a set of vulnerability indicators suitable for the national context.

Use already available national-level data at the beginning, such as the Household Budget Surveys (HBS), to identify broad patterns of vulnerability and their underlying factors.

Work to improve data sources and indicators, aiming to refine the analyses into a more comprehensive and detailed monitoring system over time.

STEP 2. DESIGN A SET OF POLICY MEASURES



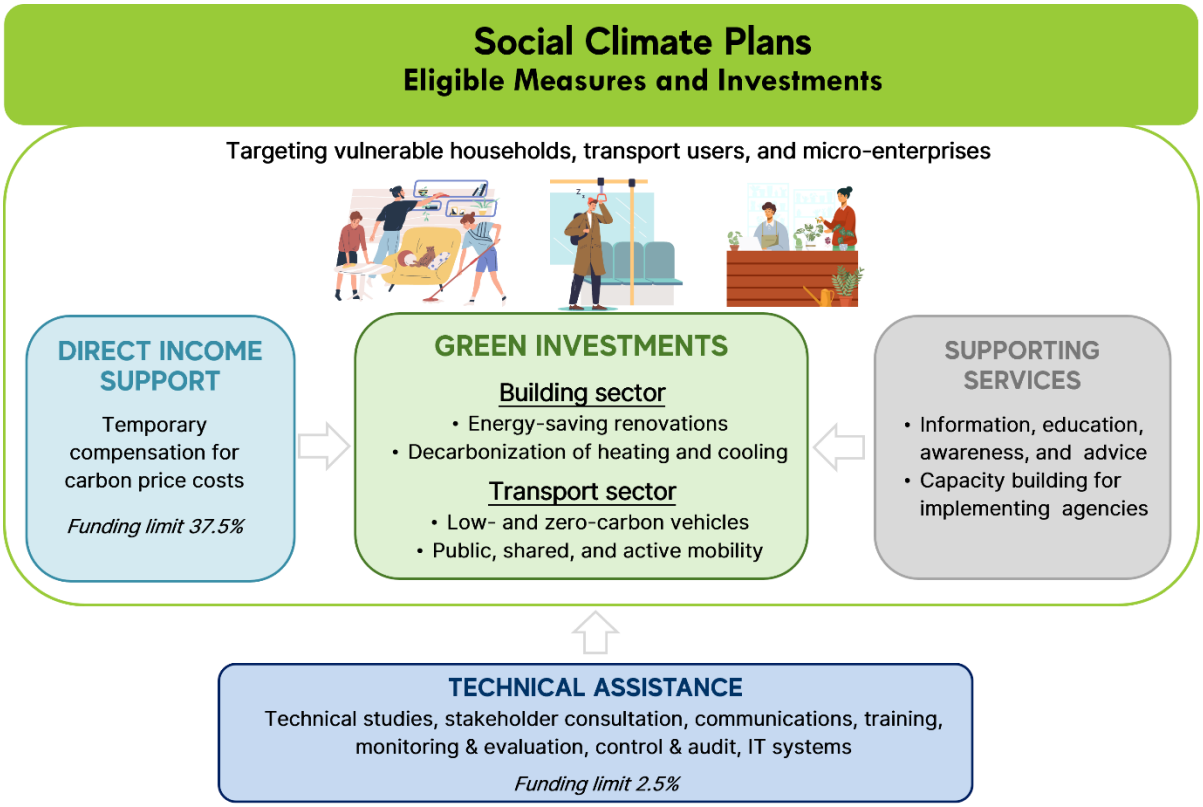
Member States are restricted in the scope of policy measures that can be included in their Social Climate Plans. However, within this scope, there is a great variety of approaches that may be pursued. Figure 4 provides an overview of the types of policy measures that are foreseen, based on the list of 'eligible measures and investments to be included in the Social Climate Plans'.[5]

- **Priority should be given to 'green investments'**, being measures and investments that reduce energy consumption in the target groups. In the heating sector, these include housing renovations, decarbonization, social housing, and integrated renewables. In the transport sector, these include e-vehicle purchase, use of public transport, and integrated mobility options. Each type of measure entails a specific policy intervention with its own realm of actors, responsibilities, and expertise.
- **Temporary direct income support** may be provided to those groups also targeted by green investments. As an accompanying measure, income support should be temporary and decline over time until the cost-saving benefits of green investments can be realized.

[5] Article 8 of the Regulation (EU) 2023/955

- **Supporting services** should be funded to facilitate the implementation of measures and investments. Information and advisory centres, working together with capable implementing agencies, are able reach vulnerable groups and foster the uptake of measures.
- **Technical assistance** and guidance are also available to Member States to build the knowledge, capacity, and networks needed to implement Social Climate Plans.

Figure 4. Policy measures eligible under the Social Climate Fund



Key considerations and challenges:

The challenge of targeting. All measures under SCF need to primarily target vulnerable households, transport users, and micro-enterprises. An effective targeting strategy is needed to identify and define eligible groups, locate households and individuals, and find appropriate channels for delivering them support. This poses challenges related to data availability and administrative feasibility. On their own, national-level indicators are usually not sufficient to target specific groups, as they lack information on individual recipients. Local geographic factors also play a role, especially where green investments should benefit whole communities or areas. Work is needed to integrate local-level data and indicators into practical targeting approaches that combine socio-economic data, such as income and expenditures, with locally specific data, such as the energy performance of buildings, connections to district heating, public and private transport networks, and proximity to basic services. However, such work can be time consuming and costly, so policymakers need a balanced approach that is both accurate enough yet feasible.

Existing indicators and channels can provide a starting point. Income level is a common indicator used for targeting social support measures, with the option to set different eligibility thresholds for progressive payments. Social transfer schemes, such as those targeting welfare recipients or pensioners, also provide options to identify and reach some groups via existing channels. However, on their own, these parameters cannot capture all relevant aspects and may exclude some vulnerable groups.

Complementary policies and frameworks need to be considered, both to overcome specific barriers and to align Social Climate Plans with relevant national and EU policy frameworks. National interventions may be needed to maintain the carbon price signal, overcome the tenant-landlord dilemma, empower multi-family housing residents, and legally protect vulnerable consumers. At the EU level, the plans should be coherent with National Energy and Climate Plans (NECPs) and aligned with several other directives, regulations, and plans, such as the Energy Efficiency Directive (EED) and the Energy Performance of Buildings Directive (EPBD).

Practical lessons can be taken from international experience. Policy design can draw on good practice examples from existing policies in Europe and North America. While no single approach perfectly fits the Social Climate Fund, each case shows practical approaches to targeting, setting eligibility criteria, engaging vulnerable groups, supporting implementation, and delivering support via different channels.

OUR RECOMMENDATIONS:

Integrate local-level data, indicators, and delivery channels into the national-level targeting strategies. This data is more available at the municipal level, where policies to tackle energy poverty and foster social development are typically implemented.

Start simple and improve accuracy over time. Implement first using available data and channels and then update the system as new and better data becomes available.

Build on good practice examples – learn from experience by taking positive aspects from policies in other countries and adapting them to your needs and objectives.

Take a holistic approach to policy design, so that the overall package outlined in the Social Climate Plan is integrated and consistent, targeting the same groups with diverse yet mutually reinforcing measures.

STEP 3. STAKEHOLDER ENGAGEMENT

The concrete measures to tackle energy and transport poverty need to be firmly rooted in the national context. Diverse sub-national stakeholders need to play an active role in their design and implementation. Member States are obliged to consult with stakeholders, including sub-national administrations and civil society groups, as part of their Social Climate Plans development process.[6] Yet, a basic top-down consultation is not enough for success. The active participation of a range of stakeholders is needed to access data on vulnerability, plan appropriate measures, open channels to target groups, and implement action on the ground.

Key considerations and challenges:

Energy and transport poverty are cross-cutting issues. Social Climate Plans therefore intersect with diverse policy objectives, such as climate protection, energy policy, economic development, public health, and social protection. Successful implementation will require the collaboration of actors in all these fields, contributing their knowledge and expertise from the national to the local levels.

Early involvement of regional and local governments, such as provinces and municipalities, is crucial as they hold the key to local data, implementation networks, and delivery channels for funding. Public and private organizations, such as social housing providers and utility managers, are in direct contact with vulnerable households, and can contribute both to targeting and delivering measures. Civil society organizations play a key role in advocating for vulnerable groups and in reaching them with measures.

OUR RECOMMENDATIONS:

Stakeholder consultation should start early in the process and focus on building awareness, exchanging knowledge, data, and expertise, and establishing networks.

Actively engage municipalities as key holders of relevant local data, such as building stock quality, energy consumption, public and private transport networks, social housing access, essential services, etc.

Hold regular meetings with stakeholders throughout the decision-making process in a transparent and participatory way to build trust and benefit from stakeholder expertise.

Develop a communication strategy to help get stakeholders and the public on board with the policy and to promote the uptake of measures.

[6] See Article 5 of Regulation (EU) 2023/955

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This Policy Brief is based on the report "Putting the ETS 2 and Social Climate Fund to Work Impacts, Considerations, and Opportunities for European Member States"

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This policy brief was produced under the project "Facilitating Socially Just Carbon Pricing in Central and Eastern Europe", a part of the European Climate Initiative (EUKI) of the German Federal Ministry for Economic Affairs and Climate Action (BMWK). The EUKI competition for project ideas is implemented by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH. It is the overarching goal of the EUKI to foster climate cooperation within the European Union (EU) to mitigate greenhouse gas emissions.

The opinions put forward in this policy brief are the sole responsibility of the author(s) and do not necessarily reflect the views of the Federal Ministry for Economic Affairs and Climate Action (BMWK).

Supported by:

Federal Ministry for Economic Affairs and Climate Action

European Climate Initiative EUKI

on the basis of a decision by the German Bundestag