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THE REVISION OF THE ENERGY TAXATION DIRECTIVE AND ITS IMPACT ON THE ROMANIAN ENERGY SECTOR

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- The current version of the Energy Taxation Directive (ETD) is deemed outdated and misaligned with the EU agenda of promoting renewable energy sources, energy efficiency and greenhouse gas emissions (GHG) reduction.

- The European Commission's ETD proposal is a unique opportunity to address some of the missing pieces of the current framework and sets the ground for encouraging the roll out of new, sustainable technologies and products by:
  - Building the tax rates based on the energy content and environmental impact.
  - Widening the taxation base, by including energy sectors that are not in the scope of the current ETD (aviation, shipping).
  - Developing mechanisms to incentivize new energy carriers and technologies, such as hydrogen and storage.

- If social risks are properly mitigated, including through exemptions for vulnerable consumers, the ETD can bring substantial changes for the decarbonization process in Romania:
  - It will motivate energy-intensive industries to shift their energy purchases to green producers, determining new wind and solar power plants to be developed, including in new geographical territories. The greatest impact could be offshore, a sector yet to be exploited at national level.
  - It will incentivize investment in energy efficiency, as well as stimulate financing of decentralized electricity production.
  - It encourages renewable hydrogen deployment, which has significant potential in Romania, considering the high renewable potential, as well as the industrial demand for hydrogen.
  - It will incentivize even more the adoption of electric vehicles, which can also help the country's urgent electricity network adequacy issues.

ENERGY TAXATION DIRECTIVE – BACKGROUND

The Council Directive 2003/96/EC restructuring the Community framework for the taxation of energy products and electricity (the 'Energy Taxation Directive' – ETD) sets EU's taxation framework for energy products, such as electricity, motor fuels, and most heating fuels. Considering EU's commitment to reduce GHG emissions by at least 55% by 2030, as well as to reach climate neutrality by 2050, a revision of the ETD was proposed by the European Commission, as part of the Fit for 55 package released in July 2021.

WHY REVISE IT?

The current version of the ETD is deemed outdated and misaligned with the EU's agenda of promoting renewable fuels, energy efficiency and GHG emissions reduction. It sets minimum taxation rates based on the volume of fuels traded, without accounting in any way for the fuel's negative externalities. This creates anomalies such as coal taxation for heating being lower than for gas, despite having twice the amount of GHG emissions. Similarly, diesel fuel has a lower taxation than petrol in the EU, even if it is more polluting for the environment.

In addition, as the minimum taxation rates have not been revised to account for inflation since the entry into force of the ETD, the current excise duty levels have no impact on disincentivizing the use of highly polluting fuels. Moreover, the current framework allows Member States to pick their own domestic derogations, exemptions, or reductions, actions often overused.

Some of the criticisms of the current ETD version also revolve around the issue of fairness. While the idea of maintaining the EU's industrial competitiveness has economic and social grounds, the current taxation framework leads to higher average excise duty rates for households than for industrial producers. As some of the Member States are facing significant and increasing energy poverty issues, a focus on vulnerable communities and their capacity of sustaining increased taxes is needed to ensure fairness and equity in energy taxation.

A successful energy transition also needs to expand the scope of climate policies to sectors currently not addressed by the ETD, which fully exempts aviation and shipping from minimum taxation rates. This does not incentivize new technologies or even pilot projects in more sustainable fuels for this transport segments.

However, as the EU ETS remains the main driving force for EU's climate neutrality ambitions, one can argue on the added value of the ETD. The ETS currently covers the electricity production and industrial sectors, with a Commission proposal to extend it to heating, cooking, and transportation currently under debate. To some, an updated and more sustainably oriented taxation framework may seem unnecessary or even redundant under these circumstances, especially as the legislative process is expected to be strenuous, given the need for a unanimous decision in the Council of the EU for measures related to taxation reform.

Still, the ETD proposal is a unique tool for addressing some of the missing pieces of the current legislative framework and sets the ground for encouraging the roll out of new sustainable technologies and products.

WHAT IS CHANGING?

The new ETD proposal aims to build a more solid fiscal instrument for incentivizing a sustainable and clean EU growth, contributing to fossil fuel phase out and thus reducing greenhouse gas emissions. Some of the most important reforms in the proposal for revising the ETD include:

- Changing the core taxation principles:
  - Building the tax rates based on the energy content and its environmental impact, as opposed to basing it on volumes traded, as it is currently the case.
  - Widening the taxation base by including energy sectors that are not in

the scope of the current ETD (aviation, shipping).

- Developing mechanisms to incentivize new energy carriers and technologies, such as hydrogen and storage (with storage technologies to be considered "redistributors," to avoid the risk of double taxation – thus not taxing both the charge and discharge of the batteries).

- Simplification of the current structure by defining five taxation categories (with the highest minimum rates being applied to traditional fossil fuels):
    - Traditional fossil fuels (petrol, gasoil, kerosene, etc.) and non-sustainable biofuels, bioliquids and certain solid biomass
    - Kerosene (for motor fuel in aviation)
    - LPG, natural gas, and non-renewable hydrogen
    - Sustainable but not advanced biofuels,[1] bioliquids and certain solid biomass
    - Electricity, advanced biofuels, e-fuels, and renewable hydrogen
- Introducing social aspects:
    - In sectors that benefit from complete exemptions (aviation, heating for non-vulnerable households), transition periods will apply for the new tax rates, to mitigate the economic and social costs of new tax rates.
    - The possibility to exempt vulnerable households from taxation of "heating fuels for a period of 10 years and introducing a transitional period of ten years for attaining the minimum rate of taxation."
- Changing application and reporting rules:
    - Additional mechanisms for limiting Member States' ability to exempt the minimum tax rates.
    - Introducing mechanisms to adjust the minimum rates based on the Eurostat price index.
    - Continuous report and review – from the Commission to the Council – on the application of the Directive (and, if the case, proposals for modification) every five years.

Assuming unanimity can be reached in the Council – a challenging process in past negotiations – the new Energy Taxation Directive should come into force in 2023, which makes 2022 an important year for negotiations.

THE ROMANIAN PERSPECTIVE

A country's economic and social context is crucial for determining the impact of the adoption of higher taxation rates for energy products. Historically, a country with significant energy poverty issues such as Romania has been affected by the lack of investments in new generation technologies. Consequently, the energy imports have increased, driving a surge in wholesale and retail prices with a direct impact on vulnerable consumers.

This local context needs to be an important consideration for Romania during the negotiations for the new ETD framework. If not managed properly, the potential double taxation on final energy bills – through carbon pricing by the ETS and the minimum tax rates on energy product by the ETD – risks increasing the country's energy poverty levels. In such a scenario, the state will need to develop social funds for vulnerable consumers, thus recycling the revenues collected through higher excise duty taxes from other energy contents, mainly fossil fuels.

However, these issues should not stop the development of a well-designed, effective, and adaptable taxation framework, able to send investment signals to market participants. Other tools can be deployed to address energy poverty concerns – the Social Climate Fund (if approved) or the current revenues from ETS auctions are two potential such sources. By imposing higher levels of taxation fairness, the revised ETD should also ensure that it is not households that are taxed the highest.

Two key challenges relevant for Romania still need to be addressed in negotiations:

[1] "Sustainable but not advanced fuels" needs to be more clearly defined during the upcoming negotiations.

- As households have transitioned in the past decades from district heating to individual gas heating technologies, an increased taxation level will deepen the affordability struggles in winter months. Returning to district heating systems may turn out to be difficult, as current infrastructure needs massive investments to sustain even the current demand. Most local authorities have moved very slowly in this regard.
- As Western governments are gradually implementing barriers for new diesel cars ownership in an attempt to phase them out, Eastern Europe continues to import more second-hand diesel cars from those countries. Increasing the already high (in relative terms) diesel excise rates, may affect the overall economy, driving inflation rate up.

Considering the massive base of vulnerable consumers in Romania, exemptions from the next taxation framework will need to be developed, especially for the heating of households. However, given Romania's track record of multi-layered exemptions (taxing on one hand, but lifting a burden on the other hand, as it was often the case for coal producers), the EU's mechanism of limiting exemption to only households, and more particularly to vulnerable consumers, is appropriate and necessary. Moreover, to implement medium- and long-term objectives, excise tax exemptions should have embedded conditionalities (e.g., adopting more efficient appliances, switching from biomass to heat pumps, etc.), most of them developed through other subsidies and incentives by state authorities.

There are also some significant opportunities for Romania related to the ETD, especially when it comes to scaling up green investments:

- A higher taxation level of fossil-fuels in the electricity sector will determine energy-intensive industries to focus their energy acquisition on green generators. This will likely lead to larger use especially of bilateral power purchase agreements (PPAs) for new wind and solar and wind power plants. Additionally, energy intensive consumers may also increase their energy efficiency levels (including through digitalization), as well as ramp up investments in decentralized electricity production. These are essential steps in Romania's decarbonization process.
- As Romania continues to have a significant and yet not fully exploited natural potential for renewable generation, an adequate taxation framework will incentivize the development of wind and solar parks in new geographical territories. The greatest impact could be in offshore areas, yet to be developed at national level.
- The ETD revision proposal also aims to encourage renewable hydrogen, which has a very high potential in Romania, given its large renewable potential, as well as the industrial demand for hydrogen. This may contribute to rapidly develop the future clean hydrogen production sector.
- Rightly implemented, the taxation directive will incentivize even more the adoption of electric vehicles. By doing so and by introducing the vehicle-to-grid (V2G) technology, Romania will also address its urgent network adequacy issues.
- Similarly, as the country's grid lacks flexibility, a new taxation framework will incentivize storage technologies by defining their operational taxation status (avoiding double taxation, a principle needed for the above-mentioned V2G process too).

The Energy Policy Group (EPG) is a non-profit, Bucharest-based independent think-tank specializing in energy and climate policy, market analytics and energy strategy, grounded in February 2014. EPG's regional focus is Southeast Europe. Its work, though, is informed by wider trends and processes at global and EU levels. EPG is committed to promoting long-term decarbonization policies and actions across all economic domains, with focus on the energy sector. We seek to facilitate objective and informed dialogue between decision-makers and a broad array of stakeholders.