



Carbon Capture – The Current State of Play in the European Union

Executive Summary

Carbon capture and storage (CCS) is the process of capturing carbon dioxide (CO₂) either from the air or from the combustion of fossil fuels or biomass, transporting it to a geological storage and injecting it there. Carbon capture and utilisation (CCU) means that the captured CO₂ is processed into a permanent chemical bond or into an e-fuel. CCS and CCU are seen as key net-zero technologies, especially for hard-to-abate industries (eg cement, lime, steel), for peak load generation in gas- and biomass-fired power plants, and for the production of e-fuels to be used in aircrafts, ships and trucks.

The market alone does not provide sufficient incentives for the development and deployment of CCS and CCU. However, there are a number of drivers arising from the EU regulatory framework:

- Avoiding CO₂ emissions through CCS or CCU will save operators of industrial plants, power plants and aircrafts, as well as (in future) shipping companies and fuel suppliers EU Emissions Trading Scheme (ETS) costs they would otherwise incur. While the EU ETS price was €3 per tonne of CO₂ equivalent in January 2013, it exceeded €100 for the first time in February 2023 as the cap on ETS allowances had been reduced. The cost savings from the ETS exemption for CCS and CCU will therefore partly – and later probably fully – offset the abatement costs of developing and deploying this technology.
- As from 2026, emissions embedded in certain goods imported from third countries (such as cement, steel and ammonia) will be subject to a price linked to the ETS price in the form of a Carbon Border Adjustment Mechanism (CBAM). This will not be the case if the CO₂ released in the production of these goods is not emitted, but captured and stored or permanently bound in a chemical. CBAM will therefore be a driver for the deployment of CCS and CCU in third countries.
- For the transport sector in particular, the draft revision of the Directive (EU) 2018/2001 (**Renewable Energy Directive II – RED II**) and various specific rules for aviation and maritime impose obligations to reduce greenhouse gas emission intensity or to meet certain renewable energy quotas, especially with

target dates of 2030 and beyond. These provisions have the potential to create an additional incentive for the use of e-fuels in the transport sector, particularly in aviation.

- CCS and CCU projects that meet certain conditions are eligible for government funding at both EU and Member State level.
- The draft Net Zero Industry Act provides for an obligation on authorised oil and gas producers to develop 50 million tonnes of annual operational CO₂ injection capacity by 2030, although the compatibility of this obligation with the EU Treaties, the Charter of Fundamental Rights and the Energy Charter is questionable.
- Subject to conditions, the development and deployment of CCS and CCU qualify under the sustainability requirements of the EU Taxonomy Regulation and could therefore benefit from a sustainability premium rewarded in equity, bond and consumer markets.

However, there are also a number of regulatory-related obstacles to the development and deployment of CCS and CCU:

- The future ETS price is subject to volatility risks and could be relaxed by a political decision to lift the ETS cap.
- There appears to be a lack of government funding for large-scale projects.
- In several Member States, such as Germany and Austria, CCS is prohibited. However, a lifting of the CCS ban is under discussion.
- The permitting for CCS and CCU projects is at risk of being significantly delayed by third-party legal challenges.
- The construction and operation of geological storage is subject to civil liability risks, sometimes with particularly plaintiff-friendly rules on the burden of proof.
- The maritime conventions OSCAR and the London Protocol set high standards for the protection of the marine environment for seabed storage.
- There are regulatory barriers to the use of CCU-based e-fuels in the transport sector, particularly for cars and also for trucks.

Briefing

This briefing explains the EU regulatory framework for carbon capture, utilisation, and storage relevant for companies and investors looking to get involved in the sector.

1. What is CCU and CCS?

Carbon capture is the process of capturing and isolating carbon dioxide, either from emissions released by activities in the industrial or energy sector, or from the atmosphere. The captured CO₂ can either be stored (CCS) or used as a feedstock (CCU). CCS and CCU technologies are widely regarded as indispensable to achieving a net-zero economy. They are expected to be deployed primarily in hard-to-abate industrial sectors, but also in the context of e-fuels particularly used for shipping and aviation. In some cases, CCS and CCU compete with renewable energy technologies (eg green hydrogen), in others they complement renewable energy technologies (wind and solar power), and in some applications they are seen as the only practical way to prevent CO₂ emissions into the atmosphere (eg in cement production).

Commercially suitable industrial sources for carbon capture include emissions from cement, lime, steel, and chemical production. Electricity generation is also a significant source of CO₂ – especially from gas and biomass-fired power plants, which are vital for providing peak load capacity in the absence of solar and wind power. In the future, CO₂ may also be extracted from the atmosphere by direct air capture, although this technology is still in its infancy.

In the case of CCS, the captured CO₂ is transported – by pipeline or vessel – to a geological storage site that ensures that the CO₂ remains permanently underground. To date, the development of CO₂ storage capacity in the EU has been concentrated in the North Sea, where well-defined geology and existing oil and gas facilities provide a favourable environment.

For CCU, there are two types of application: The CO₂ can be processed into a chemical bond where it remains permanently, such as carbonates used in construction. Or the CO₂ can be combined with hydrogen to form an e-fuel, which releases the CO₂ into the atmosphere when burned. If the CO₂ comes from industrial emissions, the industrial emissions still enter the atmosphere indirectly, with a delay, thus avoiding additional CO₂ emissions from burning fossil fuels. In a net-zero economy, which the EU aims to achieve by 2050, the CO₂ incorporated into an e-fuel would have to be captured from the air or released during biomass combustion.

2. CCS Directive

The EU has had a regulatory framework for the construction and operation of geological storage sites for CO₂ in place since 2009, Directive 2009/31/EC (*CCS Directive*). The CCS Directive sets standards for site

selection, permission, operation, and closure of CO₂ storage sites in the European Economic Area, with a strong emphasis on safety and environmental protection. But it does not cover CCU.

A cornerstone of the CCS Directive is the right of EU Member States to determine areas from which CO₂ storage sites may be selected, including the right to completely opt out of CCS in their territory. With many EU Member States having done so, the European market (and national legal frameworks) for CCS is rather fragmented. Generally speaking, CCS projects require permits (eg storage or exploration permits), with national regulatory authorities overseeing the process in order to ensure compliance with applicable safety and environmental criteria.

CCS projects also require an Environmental Impact Assessment, according to which developers are obliged to assess and address the potential environmental and social impact associated with CO₂ capture, transport, and storage activities. Cross-border CO₂ transport between EU Member States is governed by the EU Transboundary Carbon Dioxide Transport Directive (2019/692), covering transport by pipelines.

While we have not yet seen substantial amendments to the CCS Directive's legal regime, a technical update of its four guidance documents, initially published to provide an overall methodological approach for implementing the key provisions of the CCS Directive, is currently underway and will likely be adopted by the end of 2023.

3. Regulatory drivers for the deployment of CCS and CCU

The EU regulatory framework provides several mechanisms to incentivise the deployment of CCS and CCU technology.

3.1 EU ETS

The EU ETS, based on Directive 2003/87/EC (*ETS Directive*) is a cap-and-trade system that puts a price on greenhouse gas emissions (*GHG*). Operators of ETS installations, such as cement manufacturers and operators of power plants, as well as aircraft operators and, in future, shipping companies, are required to surrender ETS allowances corresponding to the amount of CO₂ emitted. The EU ETS forces emitters to procure ETS allowances in advance, either via free allowances allocated by EU Member States or by purchasing them at a market price.

Since 2013, the ETS Directive provides that emissions that have been captured and stored in accordance with the requirements of the CCS Directive do not trigger an obligation to surrender ETS allowances. According to the 2023 revision of the ETS Directive, the same applies to emissions that are captured and permanently chemically bound in a product so that they do not enter the atmosphere under normal use. This covers, for example, CO₂ processed into carbonates used in construction, but

not CO₂ processed into other products that are prone to degradation.

The EU ETS also provides incentives for the use of e-fuels: For example, emissions from the combustion of e-kerosene produced from industrial emissions in line with the requirements under the RED II are counted as zero emissions and therefore do not require aircraft operators to surrender ETS allowances. In other areas, such as the maritime sector, the Commission is also required to ensure, through implementing legislation, that emissions from the combustion of e-fuels are not counted twice and that there is consistency with the requirements of RED II.

The EU ETS therefore creates an incentive to deploy CCS and CCU technology if the cost of implementing CO₂ abatement technology is lower than the cost of procuring ETS allowances. The price for ETS allowances has developed very dynamically in recent years. While it was below €3 in January 2013, it exceeded €100 for the first time in February 2023. At least until 2030, there are currently no regulatory indications of a significant price increase, as the linear annual reduction in ETS allowances, which is envisaged to start in 2024, is already factored into the ETS price.

It should be taken into account that free allowances, which can significantly reduce the effective price of emitting CO₂, will be gradually phased out for various hard-to-abate sectors from 2026 to 2035 (eg steel and cement). For the maritime sector, the number of ETS allowances to be surrendered will be reduced in 2024 and 2025, meaning that a 100 per cent cost burden will only take effect from 2026. Furthermore, emissions from combustion-engine cars and lorry transport will be covered by the EU ETS as of 2025, with the ETS allowances price initially capped at €40 per tonne of CO₂ equivalent until 2030. A significant push from the ETS for the deployment of e-fuels for lorry transport can therefore not be expected before 2031 – unless Member States make use of their right to introduce stricter CO₂ pricing rules for the transport sector before then.

Under the current version of the ETS Directive, the generation of negative emissions, for example through direct air capture and storage, is not remunerated by additional ETS allowances. However, the European Commission is required to consider such an adjustment to the regulatory framework by 2026. Looking ahead, it is expected that negative emissions will also be included in the EU ETS and that the CO₂ price in the (late) 2030s could be determined by the cost of direct air capture and storage.

3.2 Carbon Border Adjustment Mechanism

On 1 October 2023, the CBAM Regulation entered into force. From 1 January 2026, importers of steel, aluminium, hydrogen, ammonia, cement, and other products will be required to surrender one CBAM certificate per tonne of emissions, measured in CO₂ equivalent, which are embedded in these imported goods. The price of the CBAM certificates to be surrendered and hence to be purchased will be linked to the price of ETS allowances.

Unlike the ETS, CBAM defines emissions as ‘the release of greenhouse gases into the atmosphere from the production of goods’. Consequently, CO₂ that is captured and permanently geologically stored, or processed and permanently chemically bound in a product, rather than released into the atmosphere, does not, by definition, constitute an emission and therefore cannot trigger an obligation to surrender CBAM allowances. The Commission clarifies in Implementing Regulation (EU) 2023/1773 and in its official ‘Guidance Document on CBAM Implementation for Importers’ dated 17 August 2023 that in order not to qualify as an embedded emission it must be documented and monitored that the CO₂ released is permanently stored or chemically bound so that it cannot enter the atmosphere. As a consequence, it is expected that CBAM will incentivise the use of CCS and CCU technology in third countries.

3.3 Renewable energy quotas in transport

Renewable energy quotas specific to the transport sector will mean additional drivers for the deployment of CCU in the form of capturing CO₂ and processing it into e-fuels will arise.

In particular, the draft revision of RED II and the draft ReFuelEU Regulations for maritime transport and aviation provide for various obligations on fuel producers, aircraft operators, and shipping companies to reduce the greenhouse gas emission intensity or increase the share of renewable energy sources in the relevant sector by certain target dates; some of these quota obligations cover the transport sector as a whole, while others are specific to shipping or aviation. Renewable fuels of non-biological origin (**RFNBOs**) and recycled carbon fuels represent one option for meeting these quota obligations.

However, this is subject to conditions as RFNBOs and recycled carbon fuels are only eligible if the GHG emission savings from the use of these fuels are at least 70 per cent according to Regulation (EU) 2023/1185. E-fuels can only contribute to this 70 per cent emission saving if the CO₂ processed into the fuel qualifies as avoided emissions. According to Regulation (EU) 2023/1185, this is the case if the CO₂ comes from direct air capture or from the combustion of biomass. Emissions captured from industrial or electricity production are eligible until 2041 or, in the case of electricity production, until 2036, provided that the activity is subject to the ETS or – especially in case of a third country – to another effective carbon pricing system. E-fuels produced from industrial emissions, for example in Saudi Arabia, are therefore not eligible (unless the producer buys ETS allowances and ensures their permanent cancellation). In addition, the capture of CO₂ from the combustion of an RFNBO or a recycled carbon fuel and the capture of the natural release of CO₂ from geological resources are eligible.

3.4 Net-Zero Industry Act

In March, the Commission published the draft proposal for a regulation of the European Parliament and of the Council on establishing a framework of measures for strengthening

Europe's net-zero technology products manufacturing ecosystem (Net-Zero Industry Act – **NZIA**). Among other measures, the NZIA calls for the development of 50 million tonnes of annual operational CO₂ injection capacity on EU territory by 2030. According to the draft, authorised oil and gas producers will be required to contribute to this injection capacity in proportion to their market shares in the calendar years 2020 to 2023. The draft NZIA provides that authorised oil and gas producers may make this contribution either by developing the relevant injection capacity themselves or by obliging third party developers or other authorised oil and gas producers to do so. It is questionable whether these requirements comply with the EU Treaties, the Charter of Fundamental Rights and the Energy Charter and whether the draft NZIA will become binding law. If so, it would certainly act as an additional driver for the construction of storage capacity for captured CO₂.

3.5 Government funding

The use of CCS or CCU is only commercially viable if the cost of CO₂ abatement is less than the cost of CO₂ emissions. A portion of the CO₂ abatement cost borne by the private sector is expected to be reduced by EU aid and state aid granted by EU Member States. In order to assess the profitability of a CCS and CCU project, it is therefore vital to assess whether and under what conditions aid has already been secured or can be expected.

EU aid is funded by the EU's budget and is available for both the production and operation of CCS and CCU technologies. The key sources in this respect are the EU Innovation Funds and Horizon EU. By contrast, state aid is based on EU Member States' own budgets but must be in line with EU state aid rules. State aid procedures are often very complicated and lengthy. However, the current state aid rules for CCS and CCU enjoy a number of simplifications:

- In response to current geopolitical developments, the European Commission adopted a Temporary Crisis and Transition Framework (**TCTF**) applicable as of March 2023. According to the TCTF, the Commission will consider aid granted by Member States to incentivise the production of relevant equipment for CCS and CCU to be compatible with EU state aid rules, subject to the other TCTF conditions. In particular, the aid must take the form of an aid scheme and must be granted by 31 December 2025 for the TCTF to apply.
- Together with the TCTF, the Commission adopted an amendment to the General Block Exemption Regulation (**GBER**), according to which certain state aid is exempted from the formal notification obligation under the TFEU. The GBER is now explicitly applicable to state aid for carbon capture storage and utilisation as a technology supporting environmental protection, provided it fulfils certain conditions as defined in the GBER. In particular, the aid must not exceed €30 million. Otherwise, the usual state aid notification procedure applies.

EU aid and state aid for CCS and CCU is usually conditional. CCS aid is typically conditional on compliance with the minimum requirements of the CCS Directive, while CCU aid for synthetic fuels is conditional on compliance with the standard for RFNBOS and recycled carbon fuels, including compliance with the carbon capture requirements set out in Regulation (EU) 1185/2023. Additional economic and ESG requirements are possible.

3.6 Sustainability reporting

The risk-return profile of CCS and CCU projects also depends on whether there is a prospect that equity, bond and, consumer markets will reward the development and operation of CCS and CCU with a sustainability premium.

Both the Corporate Sustainability Reporting Directive (Directive (EU) 2022/2464, **CSRD**) and the EU Taxonomy Regulation (Regulation EU 2020/852, **Taxonomy Regulation**) are crucial in this respect, as they require companies to transparently disclose sustainability metrics as part of their annual reports. Some companies will already begin CSRD reporting in 2024, while reporting obligations under the Taxonomy Regulation have already kicked in in 2022 for companies subject to (less stringent) reporting obligations under the Non-Financial Reporting Directive (Directive EU 2014/95), which precedes the CSRD. The increased transparency in sustainability reporting is intended to help investors and stakeholders take informed investment decisions, benchmark companies against each other on their sustainability journey, and encourage companies to improve their sustainability disclosures.

The **CSRD** establishes a unified reporting format on a range of sustainability topics and sustainability metrics, which are spelled out in the European Commission's European Sustainability Reporting Standards (**ESRS**). While companies must disclose their scope 1, scope 2 and scope 3 emissions, CO₂ emissions avoided by using CCS is not a separate data point under the ESRS. However, CCS will of course help keep the amount of CO₂ emissions to be disclosed low. Under ESRS E1-7 companies will have to disclose 'GHG removals and storage' resulting from their own projects or from those they have contributed to in their value chain. However, the ESRS are clear that this only refers to projects where CO₂ is removed from the atmosphere, whereas CCS prevents CO₂ from being emitted in the first place. The only tangible exception mentioned is a CCS project that is combined with bioenergy production.

The **Taxonomy Regulation** establishes a classification system for economic activities considered to be environmentally sustainable. Companies need to disclose what percentage of their revenues, CAPEX, and OPEX are derived from sustainable activities, as defined in the Taxonomy Regulation, but without there being a minimum threshold that needs to be met.

Both the "underground permanent geological storage of CO₂" as well as the "transport of CO₂" are considered potentially sustainable activities under the EU

Taxonomy's Commission Delegated Regulation (EU) 2021/2139, as they contribute to the EU Taxonomy's environmental objectives of 'climate change mitigation' and 'climate change adaptation'. Companies offering CCS as a service may claim relevant revenues as Taxonomy-aligned revenues and companies investing in relevant technologies or availing of such services may claim related CAPEX and OPEX as Taxonomy-aligned expenses. In each case, the economic activities also need to comply with specific technical screening criteria, which require, for example, that CO₂ leakage during transport is limited to a certain amount (0.5 per cent of the CO₂ transported) and that the permanent storage site meets certain minimum requirements in accordance with the CCS Directive or – if stored outside of the European Union – with ISO 27914:2017.

Furthermore, employing CCS may also help companies meet the technical screening criteria to claim other high-energy activities as being 'Taxonomy-aligned'. For example, the activity of 'electricity generation from fossil gaseous fuels' is only considered to be 'sustainable' under the Taxonomy Regulation if, inter alia, it does not exceed certain GHG emission thresholds. CCS may be a way to meet these thresholds.

4. Regulatory obstacles hampering the deployment of CCS and CCU

The regulatory drivers described above stand in contrast to a number of obstacles rooted in EU and EU Member State law.

- Perhaps the biggest hurdle is the price of ETS allowances. If the EU continues to pursue its net-zero target through the EU ETS, the price of ETS allowances will reach a level in the 2030s that makes the deployment of CCS and CCU technology commercially viable without government aid. However, the currently envisaged linear reduction path for ETS allowances, ie the ETS cap, is subject to the risk of being changed by political decision, for example due to public pressure triggered by ETS-related inflationary effects.
- The commercial viability of CCS, and in particular CCU, projects requires government support that incentivises first movers to achieve economies of scale. However, there appears to be a lack of effective governmental aid for large-scale projects to date. In addition, many EU and state aid schemes are not linked to the ETS price, leaving the risk of a macroeconomic gap to developers. An exception is the new German carbon contracts for difference funding scheme introduced in June 2023. There is also a preference in some Member States for green rather than CCS-based subsidies.
- Another hurdle is posed by Member State bans on the use of CCS technology. For example, under the current German Carbon Dioxide Storage Act, permits for the construction or operation of geological CO₂ storage had to be submitted by 31 December 2016. With the deadline (so far) not having been renewed, no CCS projects are currently eligible for permits in Germany.

Likewise, in Austria the geological storage of CO₂ is prohibited by the Federal Act on the Prohibition of Geological Storage of Carbon Dioxide. However, we have strong indications that Germany and Austria are contemplating lifting the ban, or at least making it more flexible.

- Even in the absence of a CCS ban, there is a significant risk of delay in the development of carbon storage capacity. On the positive side, the draft NZIA requires Member States to ensure that the process for granting a permit to operate a geological storage site does not exceed 18 months. However, depending on the regulations of each Member State, affected third parties, including NGOs, could challenge the permit in court, potentially delaying a final decision for several years.
- As with all infrastructure, the operation and construction of a geological storage site involves civil liability risks. However, in some Member States (for example Germany), the construction and operation of a geological carbon storage site is also subject to strict liability, sometimes with a shift in the burden of proof.
- The OSPAR (Convention for the Protection of the Marine Environment of the North-East Atlantic) and the London Protocol (Protocol to the London Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matter) set high standards for the protection of the marine environment for seabed storage, thus currently limiting the availability of suitable storage sites.
- There are barriers to e-fuels in that e-fuels are typically not the only option for meeting renewable energy quotas in the transport sector. In particular, there is competition from electrification for the general quotas for road transport and heavy goods vehicles. Regarding the maritime sector quotas, there is competition from ammonia. Further hurdles arise from the fact that in the passenger car sector various regulatory initiatives are designed to make the use of e-fuels subject to prohibitive conditions.

5. Impact of tax law on the profitability of CCS and CCU projects

While several non-EU countries like the USA, Canada or Malaysia have already implemented relevant national tax relief schemes to support investments in CCS and CCU, most EU Member States have not yet taken steps to reflect the specific circumstances of these projects in their national tax laws. Investors must thus rely on the common national taxation frameworks and observe the generally applicable EU VAT and customs frameworks to find appropriate solutions for the tax treatment of their investment, always depending on the specific role(s) a taxpayer plays within the CCS and/or CCU process (like eg CO₂ emitter, CCS technical supplier, CO₂ transport provider, CO₂ storage provider, insurer of CCS and CCU

projects, licensor of CCS and/or CCU related intellectual property).

The relatively new field of investments in CCS and CCU raises several specific questions of taxation, such as

- the qualification of storage capacities or pipelines as permanent establishments for income tax purposes,
- the qualification of CO₂ sequestration, storage and/or utilisation as part of production costs,
- tax recognition of provisions related to CCS and CCU,
- tax accounting treatment of securities furnished for CCS and CCU operations,
- tax treatment of licence fees,
- VAT treatment of supplies in connection with CCS and CCU,
- Custom duties and import VAT on imports of CO₂ and technical components, and
- applicability of general (non-CCS and CCU-specific) national R&D tax schemes.

As some of the questions raised above have a significant impact on the tax treatment and profitability of an investment in the CCS or CCU sector, careful tax planning of these investments is advisable. Legal uncertainties can be mitigated through early communication with the competent tax authorities and – where applicable – through applications for binding rulings.

6. Outlook

The profitability and diversification potential of investments in CCS and CCU technologies is significantly affected by the regulatory framework deriving from EU and Member State legislation. This regulatory framework is undergoing dynamic development, as illustrated above. In principle, we see an increase in regulatory drivers for CCS and CCU investment. However, there are still significant barriers, in particular regarding the average price of ETS allowances and uncertainty about the level and conditions of EU and Member State subsidies, but also due to remaining CCS bans in Member State legislation. In addition, tax legislation offers opportunities to influence the cost-risk profile of an investment. Developers and investors should keep a close eye on legislative developments.

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