COMMENTARY

Thinking ahead for Europe

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In the final stages of revising the EU ETS, the Parliament takes one step back

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Following the vote in the European Parliament's plenary session of February 15th, the likely shape of the EU Emissions Trading System (ETS) for the next (4th) trading period 2021-2030 is becoming clearer. In a recent CEPS Policy Insight,[1] we reviewed the proposals put forward by the Environment Committee, some of which had an adventurous bent. And now that the MEPs have cast their votes, we know that the chamber as a whole prefers a more moderate approach to EU ETS reform.

Thus, the proposed carbon inclusion mechanism, which would have obliged importers in sectors with low trade intensity (e.g. cement) to purchase allowances, was voted down. Instead, the possibility to propose such 'border carbon adjustments' in future is left to the European Commission, which is tasked with tracking climate policies in other countries in an annual carbon market report. On the other hand, the option to include the maritime sector (for all ships both departing from and arriving in the EEA) in the EU ETS was supported by the Parliament. Much like with aviation in the past, the international body representing the sector, had already voiced its opposition ahead of the vote.[2]

Of the various options to strengthen the environmental ambition of the EU ETS, the higher linear reduction factor of 2.4% was rejected. The 2.2% value put forward by the heads of state and government in the European Council of October 2014 will thus retained as the primary long-term ambition parameter.

But more ambition is being shown for the shorter term. The intake rate of the Market Stability Reserve (MSR) will be doubled to 24% for the 2019-23 period. And up to 800 million allowances

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[1] Milan Elkerbout, "The EU Emissions Trading System after 2020: Can the Parliament's Environment Committee achieve its ambitions?", CEPS Policy Insight No 2017/03, CEPS, Brussels, 10 February 2017.

[2] "IMO Secretary-General speaks out against regional emission trading system", Briefing 03, International Maritime Organisation, 9 January 2017.

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in that reserve may be cancelled, representing a volume of roughly the same size as the 'backloading' measure of 2013. The 24% intake rate will have the most significant impact on the day-to-day functioning of the EU's carbon market. The withheld allowances will be deducted from the annual auction volumes.

Currently, about 945 million and 972 million allowances are scheduled to be auctioned in 2019 and 2020, respectively. Assuming that the total number of allowances in circulation[3] remains roughly at the 1.7 billion level currently quoted,[4] the MSR would return auction volumes to similar levels as seen in 2014 and 2015, when 'backloading' withheld 400 and 300 million allowances, respectively. While this indeed represents a tighter supply, the experience from these years also shows that it does not radically alter the functioning of the system.

If the legislative process leading up to the adoption of the Market Stability Reserve can serve as a guide, the Council of Ministers will want to push back against some of the MEPs. In particular, a number of measures remain that could impact the auction revenues for member states. The cancellation of allowances will clearly affect auction revenues at some point in the future, but since they would already be inside the reserve, they are unlikely to return to the market in the short term. Nevertheless, adjusting the exact number of allowances to be cancelled may be an easy way to reach a compromise.

The higher intake rate for the MSR would diminish the number of allowances available for auction in the short term, but the revenues may be partially unaffected if the EUA price increases in response to their increased scarcity. The MSR certainly generated heated controversy before its adoption, but it is now largely met with acceptance as an existing (if not yet active) mechanism. The large majority in the EP that voted in favour of the strengthened MSR, as well as the wide stakeholder support it enjoys in general, further reinforces its acceptability today.

Perhaps the more controversial provision is the conditional reduction in the auction share by 5%, to free up allowances for free allocation to industrial sectors deemed at risk of carbon leakage. While measures to protect against carbon leakage risk are widely supported in the Council, the Parliament's final position can already be seen as comparatively supportive of industry. The flat-rate reductions in the benchmarks have been softened, free allocation will continue for all sectors at risk, and innovation support will be increased by monetising additional allowances.

In light of the Parliament's position, where does this leave the EU ETS revision for now? It is always possible that an ambitious coalition in the Council wants to reintroduce some of the ideas rejected by the Parliament again, but this does not seem very likely considering that the

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[3] This is a different number from the often-quoted 'surplus', which also includes, inter alia, all allowances in the MSR and allowances that are expected to remain unallocated. The European Commission will start publishing the total number of allowances in circulation from mid-2017 onwards.

[4] European Commission, "The functioning of the European carbon market", COM(2017) 48 final, Report from the Commission to the European Parliament and the Council, 1 February 2017.

Council represents the same countries that agreed on the European Council Conclusions of October 2014, on which the European Commission based its initial proposal.

The package would certainly improve the EU ETS compared to its current rulebook, and also compared to the first Commission proposal, owing in particular to the strengthened MSR as well as the updated benchmarks and production levels for free allocation. It does not, however, significantly alter the operation of the system nor the means of mitigating carbon leakage risk.

The question of whether the EU ETS can credibly assume the role of the 'flagship climate policy' will likely not be resolved in the near future. In 2018, the Paris Agreement has mandated an 'informal dialogue' on the collective mitigation efforts of all countries. The IPCC will then release a report on the implications of the 1.5ºC temperature target. Perhaps foreseeing this, the Parliament has included numerous clauses to review before the middle of the trading period certain key parameters of the EU ETS, including the level of the cap, border adjustments and the functioning of the MSR.

Hence, EU ETS reform may once again be on the agenda before long. This prospect also raises questions of governance: in a system that depends on stability and predictability for its long-term viability, can it expect to remain credible in the face of repeated multi-year reform processes?