

The EU ETS: the cornerstone of the EU's climate strategy



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The European Union Emission Trading System

An emission trading scheme (ETS) is a market-based policy tool aimed at reducing emissions in the most cost-effective way. It consists of:

- (i) An overall emissions cap;
- (ii) Permits, or allowances, to emit certain quantities; and
- (iii) A market where participants can trade emission allowances. Within the cap, companies receive or buy emission allowances, which they can trade with one another as needed.

An ETS delivers emissions reduction by setting an emissions cap, which creates a price signal, i.e. the price for allowances. In turn, this creates an incentive to drive production and investment decisions towards a low carbon economy.

The EU ETS represents the largest environmental compliance market globally, covering nearly 12,000 installations and half of the EU's CO₂ emissions.

Achievements ...

The EU ETS has achieved a lot since its inception in 2005.

- It has achieved emission reductions in a business-friendly manner
- It has successfully created an EU-wide, robust infrastructure
- It has raised awareness of the cost of carbon emissions and the value of investments aimed at emission reductions.
- The EU-ETS has also encouraged the uptake of cap & trade schemes around the world, particularly thanks to flexible mechanisms such as the Clean Development Mechanism (CDM).

... and challenges

Despite these achievements, the system is facing challenges. Some of those are linked to the design of the scheme. Its rigidity prevents any flexibility in the level of supply of allowances into the market to adapt to changes in demand. The problem became evident after 2009 when, as a consequence of the dampened industrial activity during the recession period, the EU ETS started to experience a growing surplus of allowances compared to the level of emissions. The fixed supply in the EU ETS prevented the system to adapt to such changes in demand levels, which led to a significantly weakened carbon price signal. The expected continued surplus in the system has put into question the cost-effectiveness of the scheme, which is why reform of the EU ETS is essential.

Quick Facts: Advantages of emissions trading compared to alternatives

Business-friendly instrument: The pre-agreed total cap of allowances ensures the achievement of an environmental goal. Within that cap, businesses are given the flexibility to achieve emission reductions at least possible cost.

Maintains the EU's internal market: The EU-wide dimension of the EU ETS ensures the same rules apply across all Member States, thereby preventing unnecessary costly adaptations that national measures cause.

Alternatives would be both costly and less efficient: Alternatives such as taxes would be more costly without guaranteeing the achievement of an environmental goal, and command and control regulations would remove any flexibility for businesses

Future Prospects: 2030 Framework and EU ETS Reform

In January 2014, the European Commission released a Communication that highlights the framework it wants to develop for the EU's climate and energy policies towards 2030. The new framework proposes a GHG reduction target of 40% compared to 1990 levels, in order to stay on track with the EU's long-term stated objective of reducing emissions by 80-95% by 2050. It also proposes an EU-wide renewable energy target, and an energy efficiency target is expected to be announced in the coming months. The multiple target approach causes uncertainty about the central role that the EU ETS will play in the EU's next climate and energy package.

Businesses believe the EU ETS should remain the central pillar of the EU's policy to develop a low carbon economy, and believe in the need for better coordination of policies that overlap with the EU ETS.

Encouragingly, as a response to the structural surplus in the EU ETS, the Commission proposed amending the design of the EU ETS, by creating a Market Stability Reserve (MSR), to provide greater flexibility of the scheme and move away from the current fixed supply of allowances. In times of large surplus, some allowances would automatically be moved into the reserve instead of being auctioned; conversely, when there are insufficient allowances in circulation, allowances would be taken from the reserve and added to the auction volumes. The reserve would address the surplus of emission allowances that has built up and provide additional flexibility in times of scarcity, and it would improve the system's resilience to major shocks by moving away from the current fixed supply.

Over the coming months, the European Parliament will play an important role in reforming the EU ETS, together with European Member States, by debating and amending the legislative proposal to create a Market Stability Reserve in the EU ETS.

Priorities for the future of the EU's climate and energy policies

- **Reform of the EU ETS**
- **Political agreement on the EU's GHG emission reduction target for 2030**, that is in line with the EU's long-term objective of reducing emissions by 80-95% compared to 1990 levels
- **Improved coordination of policies** to ensure the EU ETS remains the central policy instrument in the EU ETS, and avoid more costly strategies such as national taxes or subsidies for technologies that have become commercially viable
- **More targeted use of ETS auctioning revenues** towards climate-related purposes
- **Encourage further uptake of carbon pricing mechanisms in new jurisdictions**, but recognise that until comparable policies are put in place by the EU's main trading partners, **adequate provisions are necessary should there be a risk of the EU's climate policies causing European industry to move production outside Europe**

The International Emissions Trading Association (IETA) is a non-profit business organisation created in June 1999 to establish a functional international framework for trading in greenhouse gas emission reductions. Our membership includes leading international companies from across the carbon trading cycle. IETA members seek to develop an emissions-trading regime that results in real and verifiable greenhouse gas emission reductions, while balancing economic efficiency with environmental integrity and social equity. IETA comprises over 130 international companies from OECD and non-OECD countries.



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