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CARBON MARKET BUSINESS BRIEF

EU

EU ETS AT A GLANCE

Years in operation	Phase 1: 2005-07 Phase 2: 2008-12 Phase 3: 2013-20 Phase 4: 2021-30
Overall cap & trajectory	In 2020, the overall cap was 1,816 $MtCO_2e$. During Phase 4, the cap declines by a Linear Reduction Factor (LRF) of 2.2%.
Target(s)	-21% by 2020 and -43% by 2030, compared to 2005 emissions
Emissions Reduced to date	GHG Emissions from installations covered by the EU ETS decreased by 9.1% in 2019 compared to 2018. (European Commission, 2020) A recent study by Bayer and Aklin (2020) estimates that the EU ETS saved about 1.2 billion tonnes of CO_2 between 2008 and 2016.
Sectors covered	• Power and heat generation • Industrial processes (eg oil refineries, coke ovens, iron and steel plants) • Cement manufacturing • Glass • Lime • Bricks • Ceramics • Pulp • Paper and board • Aviation • CCS networks • Petrochemicals • Ammonia • Non-ferrous metals • Gypsum • Aluminum • Nitric, adipic and glyoxylic acids
GHGs covered	CO_2, N_2O, PFCs
# of covered entities	Approximately 11,000 installations
Allocation method	Auctioning is the default method, with varying levels of free allocation to industrial sectors based on harmonised rules
Trading rules	N/A

Use of offsets and linking	In Phase 3, installations were able to use a limited amount of international credits from the CDM and JI for compliance. From the beginning of this year (Phase 4), the use of international credits is not possible. The EU ETS linked to the Swiss ETS in January 2020, meaning EUAs are fully fungible with CHUs.
Other features	Allowances can be banked indefinitely, meaning any historic vintage can be used for future compliance. It also possible to borrow allowances from one year into the future if this is within a trading phase. It is not possible to borrow allowances between trading phases. In 2019, the European Commission implemented the Market Stability Reserve (MSR). This withholds a certain amount of auction volume based on the Total Number of Allowances in Circulation.
Penalties for non-compliance	€100/t, adjusted with the EU inflation rate from 2013 onwards. The shortfall in compliance is also then added to the compliance target of the following year
Use of revenues	At least 50% of auctioning revenues or the equivalent in financial value of these revenues should be used by Member States for climate and energy related purposes.

MAJOR DEVELOPMENTS

In March 2020, the European Commission tabled a proposal for a European Climate Law to enshrine the 2050 climate-neutrality objective into EU law. This was followed by an announcement in September 2020 of a new 2030 climate target plan, in which the Commission proposed a GHG reduction target of at least 55% below 1990 levels. The European Council and European Parliament have advocated for reduction targets of 55% and 60% respectively.

Following a public consultation, the Commission is expected to publish a comprehensive 'Fit for 55%' publication in June 2021 which is likely to include proposals to align the EU ETS with the revised 2030 climate target. This publication is likely to contain proposals to:

- Increase the EU ETS emissions reduction target
- Strengthen key EU ETS mechanisms such as the cap and/or LRF and/or MSR
- Reevaluate the share of auctioned vs. free allowances
- Reduce free allowances for aviation, and integrate CORSIA with the EU ETS
  - Only intra-EEA flights are currently covered by the EU ETS. In 2012, the EU agreed to 'stop the clock' on the inclusion of all flights into and out of EEA airports, in order to allow an international solution to be found to problem of aviation emissions. The result of this international effort was CORSIA. This scheme is currently in a pilot phase (2021-23), and the Commission is considering ways to allow CORSIA to exist either alongside or integrated with the EU ETS.
- Expand emissions trading to new sectors (eg, maritime, road transport, buildings)
  - Senior European policymakers have indicated that maritime is likely to be integrated directly into the EU ETS. The scope of such an expansion is unclear. The Commission has proposed including 'at least intra-EU' maritime into the EU ETS. It is possible that this might constitute including intra- and extra-EU shipping into the EU ETS (all ships above a certain tonnage arriving at and departing EEA ports).
  - It is unlikely that road transport and buildings will be included directly in the EU ETS. The Commission's preferred solution is to set up standalone ETSs for these new sectors that are more reflective of sector-specific abatement costs.
- Reconsider rules for use of EU ETS revenue
  - To date, Member States have been obliged to spend at least 50% of auctioning revenues for climate and energy related purposes. Under proposals to finance the Coronavirus recovery package (NextGeneration EU), revenues gained from introducing emissions trading to new sectors may be diverted for the use of centralised EU expenditure.
- Implement a Carbon Border Adjustment Mechanism
  - The aim of this new mechanism would be to counteract the risk of carbon leakage by putting a carbon price on imports of certain goods from outside the EU. The Commission has suggested four alternatives for how this mechanism could function. These include the inclusion of imports into the EU ETS, or the setting up of a 'notional

ETS' in which allowances would be pegged to the EU ETS price. Since international law prohibits the existence of both free allowances and protection through a Border Carbon Adjustment, it is likely that free allowances will reduce for sectors covered by such a mechanism.

Following the UK's departure from the EU in January 2020, it subsequently left the EU ETS at the end of 2020. A new UK ETS has been established, which will begin trading in Q2 2021. As part of the Trade and Cooperation Agreement between the two parties, the UK and EU have agreed to 'cooperate on carbon pricing' and will give linkage 'serious consideration'.

MARKET COMMENTARY

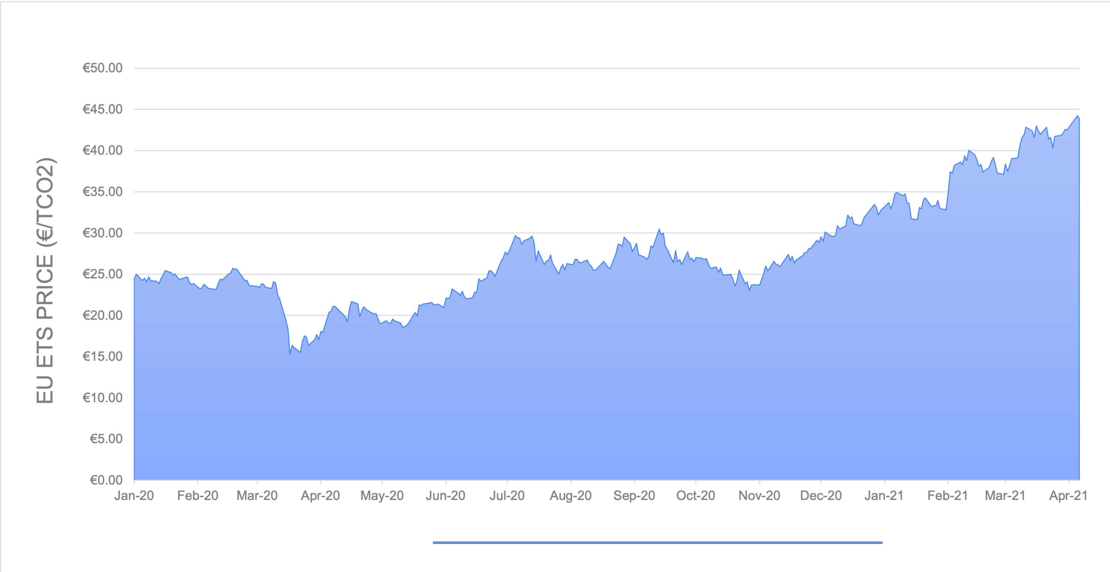

FIGURE 1
Front-December EUA daily settlement and volume
Source: ICE FUTURES EUROPE

Emissions under the EU ETS fell by 12.6% in 2020, the biggest ever annual drop, according to preliminary data from the European Commission in April 2021. The drop reflected both a slowdown in industrial output and consumption triggered by the COVID-19 pandemic as well as continued switching from coal- to gas-fired power generation.

EUA prices dipped sharply in the March-June 2020 period as the market reacted to the pandemic and drops in industrial output and power generation. The market reached a low of just above €14.30/tonne in March, before recovering to stand flat for the year at €24.50/t by mid-June.

Prices advanced nearly 33% during the second half of the year, with the front-December futures contract ending 2020 at €32.72/t, as speculative investors and some forward-thinking compliance entities crowded into the market in anticipation of even higher prices.

With the start of Phase 4 of the EU ETS on 1 January 2021, the eligibility of UN Certified Emission Reductions for compliance came to an end. Nearly 1.6 billion CERs have been surrendered by installations in the EU ETS over the preceding 12 years.

Issuance of free EUAs to industry in 2021 was delayed to June while regulators finalised benchmarks for different industry sectors, and this added to the upward pressure on prices early this year. Even reports of possible intervention to prevent excessive speculation in the market did not dampen the bullish trend, and by the end of March EUA prices had climbed above €42/t.

USEFUL LINKS

ICAP ETS Map

European Commission

EU ETS Handbook

REFERENCES

The European Union Emissions Trading System reduced CO2 emissions despite low prices. Patrick Bayer and Michaël Aklin (2020). Proceedings of the National Academy of Science, 117 (16) 8804-8812

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