IETA
CLIMATE CHALLENGES
MARKET SOLUTIONS

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	During Phase 3, the cap declines by a Linear Reduction Factor (LRF) of 1.74%, which equates to 38,264,246 allowances each year. In 2020, the cap is 1,816,452,134 allowances. Under current rules, the LRF will increase to 2.2% in Phase 4.
Target(s)	-21% by 2020 and -43% by 2030, compared to 2005 emissions
Emissions Reduced to date	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	About 11,500 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 are able to use a limited amount of international credits from the CDM and JI for compliance. Qualitative criteria apply to the types of credits that can be used. In Phase 4, there will be no use of international credits. 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

Uncertainty over both the date and nature of the UK's exit from the EU weighed heavily on the market throughout 2019. The UK – the third-largest jurisdiction in the cap-and-trade system – was due to leave the EU on 29 March 2019, and the nature of the departure would affect the UK's participation in the EU ETS:

- A 'no-deal' Brexit would lead to the UK's immediate withdrawal from the market
- A negotiated exit would see the UK remain in the market until the end of Phase 3.

This uncertainty persisted until agreement was finally reached that the UK would leave the EU on 31 January 2020, keeping the UK in the EU ETS until the end of Phase 3. The UK government has stated it would like to develop its own ETS post Brexit, which could link to the EU ETS, but it is unclear at this stage what such a market or linkage would look like, or how quickly a linkage could be made. It is also planning legislation for a carbon tax as an alternative pricing option.

January 2020 also brought the activation of the link between the EU and Swiss carbon markets, after 10 years of negotiations which were often held up by non-carbon market issues. This represented an important milestone in the global development of emissions trading as it is the first time two national/supranational markets have been linked.

This year will be busy in terms of policy development as the European Commission has published:

- A proposal for a European Climate Law to enshrine the 2050 climate-neutrality objective into EU law. The proposal aims to establish 'a framework for the irreversible and gradual reduction of greenhouse gas emissions and enhancement of removals by natural or other sinks in the Union'
- A public consultation on its plans to increase the 2030 GHG reduction target to at least 50% below 1990 levels, and toward 55%. Following the consultation, the Commission will put forward a comprehensive plan to increase the EU's 2030 climate target in September 2020. At the end of April, the lead Parliamentarian for the issue called for a 65% reduction target for 2030, setting the stage for negotiations.

Later in 2020, the European Commission also expects to consult on their plans to introduce 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 and ensure long term goals are met.

Many of these developments will culminate in a full EU ETS review in June 2021, which is likely to include:

- A more ambitious 2030 target.
- The first review of the MSR, which will assess key parameters of the mechanism such as the withholding rate and the surplus bands.
- Reducing free allowances to airlines over time and extending the EU ETS to new sectors. Before her five-year mandate started, President von der Leyen stated that she would propose extending the scope of the EU ETS. This would start with the maritime sector but could potentially include road transport and buildings at a later stage.
- A proposal for the introduction of a carbon border adjustment mechanism.

MARKET COMMENTARY

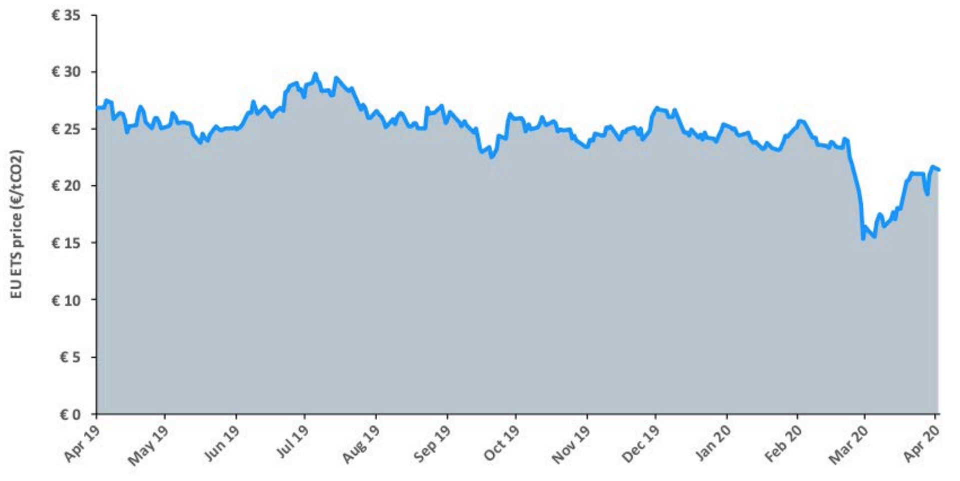

FIGURE 1
EU ETS Price Data
Source: ICE FUTURES EUROPE

In 2019, the front-year EUA contract averaged €24.90/t, €9/t higher than the year before. Over the course of the year, a total of 6.8 billion allowances (both EUAs and EUAAs) changed hands, representing a 13% decrease in traded volume from 2018. However, due to higher prices over the year, the market value of the EU ETS rose from €130 billion to €169 billion, according to analysts at Refinitiv.

Prices peaked in July 2019 at €29.81, the highest level since 2006. This increase was driven by a record-breaking heatwave across Europe which in turn increased demand for electricity while reducing output from some low-carbon generation such as nuclear and hydro.

In 2020, the main driver of prices has been the economic impact of the COVID-19 pandemic. Between 10-18 March, prices decreased by nearly €9, dropping from €24.10 to €15.30. However, by early April prices had recovered somewhat and once again closed above €21.

Looking further ahead, risks to watch include the Commission's review of the bloc's 2030 target and sector coverage, and whether the UK does quit the EU ETS as planned. The full impact of the COVID-19 on the economy also remains unknown.

USEFUL LINKS

ICAP ETS Map

European Commission

EU ETS Handbook

REFERENCES

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