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THE EU ETS: A MASTERPIECE OF CARBON MARKETS?

RECENT REFORMS

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Recent Reforms

Summary of Key Findings

Problem: Significant Number of Surplus Allowances

Yet even as the European Union Emission Trading System (EU ETS) remains the largest carbon market, which covers more than 11,000 power stations and industrial plants in the 28 EU Member States, Iceland, Liechtenstein, Norway and intra-EU flights, the system has been recently criticized due to the lack of an effective carbon pricing globally. Largely as a result of the economic crisis, fossil fuel prices and other drivers, **the growing supply of allowances** (permits) to emit has increased in the observed price evolution since 2008. A large "imbalance between the supply of and demand for allowances" has been the biggest obstacle in the European carbon market.

Updates on the European Carbon Market

The European Commision lines up "structural measures" to limit the growing surplus of emission allowances for the last two years. Updates in the European Carbon Market such as "**Back-loading"; the Commission's proposal for "2030 targets" and "Market Stability Reserve (MSR)"** remain hot topics on the European Agenda to reform and strength the EU ETS. However, legislative procedure has been so far slow in the European institutions and national authorities. If not addressed, imbalance will affect the ability of EU's competiveness in global markets as well as to meet near-future de-carbonization targets by 2050. Similarly, the current carbon price is around 6 Euro per ton of CO_2[1] but this figure is still far low to encourage investments into low-carbon technologies and green business options.

A Difficult Choice, but A Must One

What the EU need is a strong push from Member States to ensure a decisive action taken to improve targets of the EU. Especially, the proposal for MSR and other drivers (aviation sector, Energy Efficiency Directive-EED and the like) are hard, but must policy choices for the EU. This is because the existing problem of surplus risk of allowances is linked to these actions and requires a **"combination"** with setting milestones to 2050 goals. Therefore, the biggest quiz for the EU will be on-going reforms in the EU ETS.

[1] *Point Carbon*, 9 September 2014, http://www.pointcarbon.com/

"Pause" For Emissions from Aviation By 2016

As of 1 January 2012, airlines flying into or departing from the EU are subject to the EU ETS and required to surrender carbon permits equaling their emissions. After a long debate in both European and global meetings, there are now no allowances to be surrendered from aviation sector between 2013 and 2016. In reaction to conclusions at International Civil Aviation Organization's (ICAO) meeting in October 2013, the European Parliament (EP) voted in favour of "pause" decision for emissions from aviation sector until 2016. Currently, this step made **ICAO**'s hands more powerful in the issue of reforming global aviation sector. It becomes **more active organization** even on the Commission's proposal so-called "Stop the Clock". While a market-based measure (MBM) at global level has been proposed as a certain solution at ICAO's meeting, however, it is too early to evaluate the period up to 2016.

Note: *"Stop the Clock Decision" and "Back-loading Proposal" of the European Commission should not be viewed as the same amendments on the EU ETS. There is no linkage between these legislative acts.*

A Pathway to Paris 2015

The greatest threat to carbon trading is economic "uncertainty" over the market before the UN Summit in Paris 2015. **The deal of carbon** price will be vital for success of the Summit. Furthermore, The Climate Summit will be launched in New York on 23 September 2014. Considering the new international climate agreement, which is accepted to be signed in Paris (2015), the Summit constitutes an extremely important event in order to build "political" momentum for boosting impetus for climate change actions.

This working paper aims to highlight key documents to understand *recent debates on the EU ETS and near-future climate change targets of the EU.*

Detailed Findings

"…Our carbon market is delivering emissions reductions, but because of the oversupply in the market, the EU ETS is not driving energy efficiency and green technologies strongly enough. This is bad for Europe's innovation and competitiveness. This is why as a first immediate step; we propose to delay the auctioning of 900 million allowances in the next three years..."[2]

Connie Hedegaard, Former European Commissioner For Climate Action

1. Key Documents

Globally, 39 national and 23 sub-national jurisdictions have implemented or scheduled to implement carbon pricing instruments, including emission trading systems and taxes, according to the World Bank. Carbon policies can be either taxes or "cap and trade" system. The EU ETS is the largest carbon market of emissions trading worldwide and heart of the EU's climate change policy, which operates as a "cap and trade" mechanism. Yet even as it remains the largest carbon market compared to other functioning markets, the system has been criticizing due to the a significant number of surplus of allowances, which counted more than 1.5 billion to up to 2 billion that is expected to grow over the coming years to more than 2.6 billion by 2020[3].

Why does the market experience such surplus of allowances? The main reasons for the unstable figure of the price are economic crisis, fossil fuel prices as well as other drivers. Due to the crisis, the fall in the energy consumption led to a decrease in the demand for allowances. The decreased demand *(See Table 1)* is also due to the overlapping reduction targets. This means plants covered by the EU ETS polluted more rather than reducing emissions.

Table 1. Build-up of a surplus of unused allowances: 2008-2011, EU

Million ton	2008	2009	2010	2011	Total
Supply: Issued allowances and used international credits	2076	2105	2204	2336	8720
Demand: Reported emissions	2100	1860	1919	1886	7765
Cumulative surplus of allowances	-24	244	285	450	955

Source: *Community Independent Transaction Log, data 2011 as published on 2 May 2012, European Commission*[4]

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[2] European Commission, "Emission trading: Commission presents options to reform the European carbon market", *Press Releases*, Brussels, 14 November 2012, http://europa.eu/rapid/press-release_IP-12-1208_en.htm

[3] European Commission, "Proposal for a Decision of the European Parliament and of the Council concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC", COM(2014) 20/2, Brussels, 2014, http://ec.europa.eu/clima/policies/ets/reform/docs/com_2014_20_en.pdf

[4] The data can be seen at http://ec.europa.eu/clima/policies/ets/cap/auctioning/docs/swd_2012_234_en.pdf

Hereby, the European Commission prepared **the report** addressing the structural problem of the EU ETS in 2012. Subsequently, the Commission took **two critical steps** to put the imbalance of the growing supply-demand in order.

Key Documents:

- **The Commission's Report**[5]: Setting out six options for "long-term" solutions
- **Back-loading Measure**[6]: Postponing 900 million allowances in phase 3 for "short-term" solutions
- **The Proposal for MSR**[7]: "Structural reform" for the market as part of 2030 framework for climate and energy policies (expected to start in 2021, Phase 4).

Six Options from the Commission

The report from the Commission to the EP and the Council published on 14 November 2012 analyzes the functioning the European carbon market and reconsider whether regulatory action is needed. Following stakeholder meeting in March 2013, the report identified the need for tackling the imbalance between the supply of and demand for allowances. The report responds to the call of the EP and the Council made in the context of the Energy Efficiency Directive (EED).

Six options for structural measures as mentioned below:

- Emission reduction target from 20 % to 30 % by 2020
- Retiring a number of allowances in phase 3 on a permanent basis
- Ensuring the EU's competitiveness in key low-carbon technologies and limiting the risk of carbon leakage
- Introducing the EU ETS expanding to be included other sectors
- Accessing to international credits after 2020
- Discretionary price mechanisms

The surplus risk mentioned above could affect the ability of the EU ETS to meet more demanding emission reduction targets cost-effectively unless improvements in the EU ETS are taken, according to the European Commission's term. Regarding to their impacts in the market, the interaction with other policy areas and sectors will need further analyzes while considering these six options.

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[5] European Commission, "Report From the Commission to the European Parliament and the Council-The State of the European carbon market in 2012", COM(2012) 652 Final, Brussels, 14 November 2012, http://ec.europa.eu/clima/policies/ets/reform/docs/com_2012_652_en.pdf

[6] Commission Regulation (EU) No 176/2014 of 24 February 2014 amending Regulation (EU) No 1031/2010 in particular to determine volumes of greenhouse gas emission allowances to be auctioned in 2013-20, 24 February 2014, Brussels, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.056.01.0011.01.ENG

[7] European Commission, "Proposal for a Decision of the European Parliament and the Council concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC", COM(2014) 20/2, Brussels, http://ec.europa.eu/clima/policies/ets/reform/docs/com_2014_20_en.pdf

What is the main purpose for Back-loading?

Back-loading provides a "first stage" of reforms to address the risk of surplus of allowances. The year 2012 emerged as another difficult year for the EU in terms of effectiveness of the EU ETS. At the start of the third phase (2013-2020), the EU ETS was characterized by a large imbalance between supply and demand of allowances.

Hereby, Brussels took steps to fix the European Emission Allowance prices, which decreased from 30 Euro in 2008 to less than 3 Euro in 2012. Commissioner Connie Hedegaard (DG Climate Action) announced her intention to propose to postpone auction volumes from the early to the phase 3, which runs from 2013 to 2020. As a short-term measure, the European Commission proposed the draft amendment on **postponing (back-load) 900 million EU ETS allowances in phase 3 from the years of 2013-2015 to 2019-2020** in order to monitor the functioning of the European carbon market.

Table 2. Proposed Back-loading Allowances (million)

Year	2013	2014	2015	2019	2020
Proposed change in auction volume	-400	-300	-200	300	600

Table 3. Important Dates for the Proposal

12 November 2012	The Commission submits a draft amendment
14 November 2012	The Commission's Report was published: *The State of the European Carbon Market in 2012*
29 November 2012	EU Member States needs to take a position for the draft
16 April 2013	European Parliament (EP) voted against the draft
3 July 2013	EP gave a positive vote *(see "vote counts" below)*
8 November 2013	EU Member States endorsed a mandate to start negotiations with the Parliament
10 December 2013	The Climate Change Committee discussed the draft
19 December 2013	The Commission decided to schedule a meeting for voting the draft in the Climate Change Committee on 8 January 2014
16 December 2014	A formal adoption by the Climate Change Committee
8 January 2014	The Climate Change Committee agreed on the draft
22 January 2014	The Commission launched the reform on EU ETS
6 February 2014	EP endorsed
22 February 2014	The Council's endorsement

What 28 Member States Say in the EP for Back-loading[8]

In favour: Germany-France-Italy-UK (29); Romania (14); Holland (13); Hungary-Belgium (12); Sweden-Bulgaria-Austria (10); Denmark-Croatia-Ireland-Finland-Slovakia-Lithuania (7); Luxembourg-Slovenia-Latvia-Estonia (4); Malta (3) **Against:** Poland (27); Greece (12); the Greek Cypriot Administration of Southern Cyprus (4) **Unknown:** Spain (27); Portugal-Czech Republic (12)

Despite the reform, the Commission acknowledged that its proposal to back-load allowances auctioned in the EU ETS will not be enough to save the EU ETS. The problem is not only the mentality of Brussels, but also concerns what the current policies cover in order to determine a cost on the practice of emitting GHGs[9]. Accordingly, a structural measure for the European Carbon Market is required in the long-term.

Why such Market Stability Reserve?

A legislative proposal was presented by the Commission to establish a market stability reserve for the EU ETS, **as a part of the 2030 framework** for climate and energy package in line with the 22th of January 2014 decisions. The reserve is also expected to be established by the beginning of the Phase 4, 2021. The Commission highlights that the economic impact assessment has shown that the establishment of MSR could help address the current imbalance.

On 25 June 2014, a technical meeting of experts was convened to examine its impact on the balance of growing supply-demand of the EU ETS. The most common message reflected by the stakeholders and experts was that MSR seems to be a proposal that goes in the right direction in terms of long-term solutions.

But anti-MSR messages come from Britain and Germany by outlining some priorities for evolution of the EU ETS beyond 2020 (Phase 4): To Britain, "the principal objective of the EU, based on the fundamental mechanics of the EU ETS, should be to address the existing surplus in combination with setting a cap trajectory from 2020 to help meet overarching emissions reduction milestones to 2030 and 2050." The Britain calls for permanently cancelling carbon permits and is keen to built comprehensive reforms, which could keep the EU ETS as a mechanism that is fit-for-purpose to bring about a cost-effective transition to a low-carbon economy future for the EU. London also weighs up a separate proposal from Germany[10]: As another dominant actor in debates, Germany calls for its earlier introduction in 2017, 4 years earlier than proposed by the European Commission. The German government wants the 900 million allowances delayed from sale under the back-loading rather than re-introducing them to the market as proposed by the Commission.

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[8] "EU Climate Policy: Back-loading, ETS Reform, 2030 GHG Targets", International Emissions Trading Association (IETA), 6 November 2013, http://www.ieta.org/assets/3-Minute-Briefings/euets-update6november2013.pdf

[9] "Climate and Carbon: Aligning Prices and Policies", Organization of Economic and Cooperation Development (OECD), 2013, http://www.oecd.org/environment/climate-carbon.htm

[10] More information can be seen at http://www.theguardian.com/environment/2014/jul/16/uk-calls-for-cancelling-of-carbon-permits-to-revive-eu-emissions-trading

2. Other Drivers

- ***Aviation:*** The inclusion of aviation sector in the EU ETS is still a debatable and sensitive issue when it comes to future revisions of the EU ETS. In the light of the Commission's Proposal amending the EU ETS Directive (2008/11/EC) and started by 1 January 2012, aviation activities of aircraft operators that operate flights arriving at and departing from the EU was included in the EU ETS. However, this created a great criticism on the part of operators. The EU presented "Stop the Clock" Proposal in order to provide time for the next ICAO Meeting in 2013. On **4 October 2013 at ICAO Meeting**, significant progress was made by agreeing on a roadmap for developing a global market-based mechanism (MBM) as a solution in political level. The global MBM is to be finalized in 2016 and implemented in 2020. The EU also approved such solution in view of extending "Stop the Clock Decision[11]" (adopted in April 2013) until 2016, under the conclusions of the 4th March 2014 ICAO Meeting. This means that the EU will not require allowances to be surrendered for emissions from aircrafts until 2016. The Regulation came into force on 30 April 2014 and is applicable as of 1 January 2014.

- ***A Common Framework: EED***

The Directive on Energy Efficiency which entered into force on 4 December 2012 is designed to reach the EU's 20-percent energy saving policy by 2020. While provisions were implemented by Member States on the 5th of June 2014, there has been no full transformation among Member States. Importantly, the publication of EED has been another fact affecting carbon prices in line "with new face" of reduction legislative act in the EU.

Conclusion

The year of 2008 illustrated that climate change policies on the national agenda is likely to prove sensitive in fulfilling the global requirements. The crisis had a significant impact on industrial production. Currently, it is still being tested at economic uncertainty. In the face of economic uncertainty, the European carbon market is in decline. The 2030 package is also expected to be approved in October 2014. But the EU ETS is still suffering from a large oversupply of permits. According to market analysis, the global carbon price needs to be reached at 150 USD per tonne if the EU ETS needs to avoid the risk of climate change globally. Above all, without any decisive action to fix the EU ETS, the system is getting far away from being "a masterpiece" of global carbon markets.

In May 2014, the UK government proposed to set a 2030 reduction target of % 50. The European Commission also submitted these legislative proposals (2030, MSR) to the Council and related Committees for further debates under the legislative procedure. While recent reforms are under consideration in European level and economic uncertainty is at present on both global and European level, there will be no enough

[11] The Decision can be seen at
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:113:0001:0004:EN:PDF

time to fix the European carbon market. A low legislative procedure can also create a level of further surplus of allowances in the market. Importance of further action and **"adaptability" of the Member States** is still vital.

As agreed at the Copenhagen Accord in 2009, deep cuts in global emissions are required so as to ensure a "collective mitigation" among the Parties. Hence, effective mitigation will only be achieved if national authorities stop their own interests dependently. Apart from an international climate change agreement, it is very certain to mention that the deal of carbon price will be vital for success of the UN Summit in 2015.

In line with its March and June 2014 conclusions, the European Council stressed the importance of **"a coherent European energy and climate policy"** to manage obstacles in the market and meet the EU's near-future targets. In that context, The Council highlighted the importance of developing concept of the 2030 framework, a review of the Energy Efficiency Directive (EED) and how long-term measures (MSM, aviation) can contribute to the targets for 2050 and 2030 framework. In line with agreed ambitious EU objective for 2050, the current process requires more comprehensive and coherent voice among the Member States. This is crucial for EU's economy and **confirming EU's governance role** globally. By the end of 2014, **more decisive actions** would hopefully be on the table of the October Council to be mobilized to meet this agreed deadline announced by the Commission.