



## A strong revision of the EU ETS, but the future may bring impetus for further reform

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*The ETS will be much stronger after the Phase 4 revision. But further adjustments may be inevitable in the future, given ongoing developments in the climate/energy world.*

In the wee hours of November 9th, agreement<sup>1</sup> was reached in a trilogue session between the European Parliament and the Council over the European Commission's proposed revision of the EU emissions trading system (EU ETS), bringing to an end nearly two and a half years of political talks. The agreement on the Phase 4 (2021–2030) legislation significantly strengthens the functioning of the EU ETS, even if some of the improvements will take time to materialise. It also marks a step in a process of ongoing EU ETS reform: The initial proposal by the European Commission of July 2015 was released only a few months after the deal on the Market Stability Reserve (MSR) was reached, which in turn was conceived only shortly after an ad-hoc deal on 'backloading' allowances was struck.<sup>2</sup>

The ongoing reforms of EU climate policy reflect the precarious balance between environmental ambition and the demands of the political economy facing policy-makers and stakeholders. Yet, it is conceivable that 2018 could be a rare year – and the first during the third trading phase (2013–2020) – in which EU legislators are *not* discussing the reform of the European carbon market. How long will this lull last? In the end, much of the discussion in recent months between the Council, Parliament and Commission centred around a simple, specific and highly political point: Can funds generated by the sale of ETS allowances and earmarked for aiding the transition to cleaner energy systems in lower-income member states be spent on coal-fired power plants? The answer is a qualified no.

But the larger effort of reforming the EU ETS has primarily involved two broader questions: How can we make the EU ETS a more effective climate policy tool, and how can we protect (or

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<sup>1</sup> See announcement on DG Climate Action website, "[EU Emissions Trading System](#): landmark agreement between Parliament and Council delivers on EU's commitment to turn Paris Agreement into reality", 9 November 2017.

<sup>2</sup> Both backloading and the MSR adjust the timing of auctions of EUAs throughout EU ETS trading periods so as to make the supply of allowances more flexible relative to demand.

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support) the competitiveness of industry whilst doing so? The first issue relates to the perception<sup>3</sup> shared by some stakeholders that carbon prices in the EU ETS (roughly hovering between €4 and €8 since the beginning of the current trading phase in 2013) are too low to make a meaningful contribution to emissions reductions, as well as to the fact that the supply of allowances has long outstripped demand, leading to a persistent surplus of EUAs in the market.

While a number of final details depend on the exact wording of the deal, which is pending approval from COREPER (expected on November 22<sup>nd</sup>) and rubber stamping from the Council and Parliament, the main features of how the EU ETS will operate after 2020 have been known for some time. Earlier commentaries<sup>4</sup> describe in particular the potential significance of the strengthened MSR and benchmark updates.

The European Commission perhaps envisaged that the issue of price and supply would not play a dominant role in these Phase 4 discussions. After all, we had just spent a number of years discussing backloading and the MSR, which dealt with precisely that topic. However, just as was the case during those discussions, in which concerns about carbon leakage were constantly brought to the fore, so too did concerns about price, supply and environmental effectiveness come back with a vengeance during the Phase 4 talks. The temporary doubling of the MSR's intake rate to 24% was arguably among the most significant changes the revision has brought. One might yet ask if reducing supply-side flexibility, by reverting back to 12% after five years, is beneficial, given the many factors that can influence the demand for allowances. Furthermore, while the general mechanism of the MSR remains unchanged, it is altered in one fundamental respect: allowances taken into the reserve will not necessarily be released in the future, as EUAs in the MSR that exceed the number of allowances auctioned in the previous year will be cancelled. In other words, the MSR is no longer cap-neutral and could contribute to a gradual tightening of the cap.

On mitigating the risk of carbon leakage, we can conclude that free allocation will become more dynamic. The split between auctions and free allocation is no longer fixed, with up to 3% of the auction volume available for free allocation, in order to avoid triggering a cross-sectoral correction factor (CSCF) for allocation to sectors exposed to the risk of carbon leakage. Whether a CSCF will really be avoided will also strongly depend on the updates to the benchmarks. Benchmarks ideally reflect technological progress as closely as possible. But whenever the proposed lower bound of 0.2% applies (if efficiency improvements realised are modest) to some of the biggest emitting industrial sectors – steel, refineries, cement and chemicals account for almost three quarters of industrial GHG emissions – a re-application of the CSCF may be inevitable, especially if there is further output growth in these sectors. Nevertheless, the situation that arose under the current rules, in which some installations

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<sup>3</sup> See Milan Elkerbout and Christian Egenhofer, "[The EU ETS price may continue to be low for the foreseeable future](#) – Should we care?", CEPS Policy Insight No. 2017/22, CEPS, Brussels, June.

<sup>4</sup> See, for example, 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, February.

received many more allowances than they emitted simply because their output had decreased compared to the historical levels used to determine their free allocation quantities, is likely to be a thing of the past. Output levels will be updated every five years, while year to year dynamic updates (if an as of yet to be determined threshold is exceeded) ensure that free allocation levels follow actual output more closely.

Beyond the core functioning of the EU ETS, much political capital has been spent on ring-fencing a number of allowances to create specific funds: for new entrants, for innovation and to support the transition and modernisation of the energy systems in lower-income member states. The latter two initiatives stole the limelight as potentially funding coal-generation investments met with considerable opprobrium, but the innovation fund is perhaps the most critical. Most energy-intensive industries will need breakthrough technologies to enable deeper emissions reductions that go beyond efficiency improvements. Finance to support the development and uptake of such technologies will be indispensable to achieve the 2050 climate targets. But 500 million allowances over 10 years, at current carbon prices, amount to less than €4 billion in funding. Is it realistic to expect that such a sum can contribute significantly to the transformation of energy-intensive industries in a Union of half a billion people?

With the benefit of hindsight, the wisdom of treating as separate processes what are essentially two sides of the same coin is questionable. If stakeholders expect the cost of compliance to change, the potential impact on competitiveness will understandably raise concerns. Likewise, if safeguards to competitiveness are adjusted, for example, by changing the rules of free allocation, then the question of *if* and *how* this affects the functioning of the instrument as a whole is not unjustified.

Nevertheless, the post-2020 revision that has just been agreed is, unlike backloading and the MSR, part of the 2030 Framework adopted by the European Council in October 2014. Notably, the Conclusions from the heads of state and government at the time were considerably detailed and prescriptive – and they have proven resilient. The final deal closely conforms to these Conclusions, including the annual reduction of the cap by 2.2%, despite the efforts of some member states and MEPs to strengthen the cap more progressively. Conversely, some proposals that were more ‘radical’ in character compared to the current EU ETS design, such as introducing more differentiation in carbon leakage risk or including certain importers in the ETS, often ran into resistance for deviating too much from the political guidance of the European Council. This doesn’t mean that the revision process was static. The doubling of the MSR intake and the cancellation of allowances represent strong reforms that arose during the legislative process, even if their impact will take time to materialise. The fact that over the course of this process over 195 countries signed (and ratified) a historic international climate change agreement may be a part of the explanation.

So, will this deal on the post-2020 rules bring an end to a virtually continuous process of EU ETS reform? While the main EU ETS Directive may be left untouched for some time now, the European Commission will still need to draft numerous implementing rules on carbon leakage,

benchmarks and free allocation. In 2018, at the international level, the Fijian Presidency of the Conference of the Parties (COP) will launch a stocktaking exercise (Talanoa Dialogue<sup>5</sup>) of the climate plans submitted so far by the signatories under the Paris Agreement.

At the EU level, the European Commission will review the 2050 roadmap for a low-carbon economy, dating back to 2011, which introduced the 80-95% GHG emissions reduction target on which both the 2030 Framework and this EU ETS revision are based. In member states, future national climate and energy policies may interact with the European carbon market. Even the EU ETS legislation itself contains provisions to review the MSR parameters early on in the fourth trading phase. Therefore, even if the EU ETS will be stronger when Phase 4 starts, the EU's carbon market might once again demand political attention before too long. Enjoy the lull while it lasts.

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<sup>5</sup> Talanoa is a traditional word used in Fiji and the Pacific to reflect a process of inclusive, participatory and transparent dialogue (see <http://unfccc.int/items/10265.php>).