

The EU Emissions Trading Scheme – An Introduction

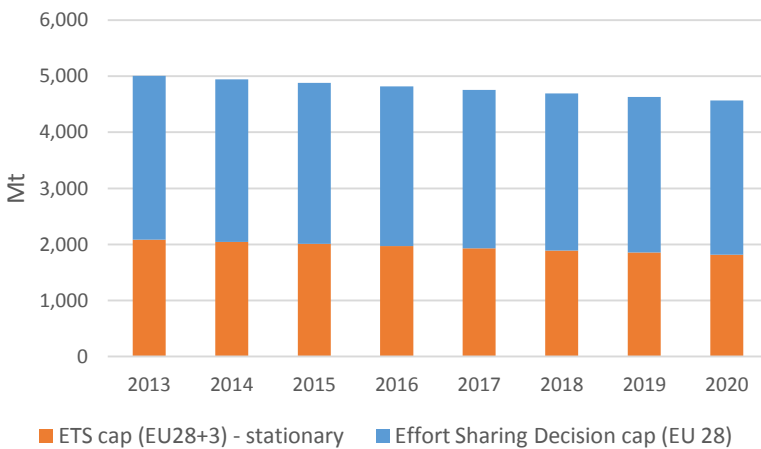
To prevent the most severe impacts of global warming, the international community has agreed that global temperatures should rise no more than 2°C compared to pre-industrial times. The EU, wanting to demonstrate international leadership, has set itself a binding target to cut its emissions by 2020. To do this, the largest emitters in the EU were brought under a single emissions trading scheme (ETS). This cap-and-trade system allows them the flexibility to find the cheapest ways to cut emissions

The basics of cap-and-trade:

The cap: The entities regulated under the ETS are private companies whose emissions are very large. Under the scheme these companies receive a set amount of allowances – one for each tonne of CO₂ that their installations are allowed to emit. The total amount of allowances in the ETS is set to fall over time. This is what dictates the level of ambition for the ETS.

The trading: Companies are encouraged to cut their emissions in any way they see fit. Their emissions cannot exceed their allowances, but those who cut their emissions more aggressively will have spare allowances. These allowances can be sold to companies who did not cut their emissions sufficiently. In this way everyone in the scheme benefits from the cheapest sources of emissions reductions being made first.

The role of the ETS in the EU's broader climate policy:



EU law mandates that between 1990 and 2020, emissions must fall by 20%. Not all of these cuts are to be achieved under the ETS, as 55% of the EU's emissions, e.g. in transportation, buildings and agriculture, are covered by the *Effort Sharing Decision*. Nevertheless, two thirds of the EU's 2020 target is to be achieved by cuts under the ETS.

The carbon price:

The supply and demand of allowances allows a carbon price to emerge. Investors have to factor in this price when making decisions. In order to put Europe on a path towards decarbonisation it is important that this price be meaningful and reliable over the long term.

Offsetting:

The *flexibility mechanisms* under the Kyoto Protocol make it possible to receive credits from cutting emissions abroad. In the ETS, an installation can use these offsets to comply with their obligations as an alternative to reducing its own emissions. Cheap offsets reduce costs for companies, but if too many offsets enter the scheme the carbon price can fall dramatically, diminishing incentives to engage in domestic abatement.

Coverage of the EU ETS:

The installations whose emissions are currently capped under the ETS are from the following sectors:

- Combustion (electricity)
- Cement and lime
- Mineral oil
- Iron and steel
- Chemicals
- Pulp and paper
- Coke ovens
- Glass
- Non-ferrous metals
- Ceramics
- Aviation (intra-EU)
- Metal ore roasting

The current state of the ETS:

The carbon price imposed by the ETS is supposed to drive low-carbon investment. However, currently the carbon price is very low (€ 5.50). This is because over the mid- and long-term, instead of being short, the market will actually be oversupplied with allowances. Today the surplus stands at roughly 2 billion tonnes, and it is set to rise to 2.6 billion tonnes by 2020. This is more than a full year's worth of allowances.

This situation has emerged because:

1. **Over-allocation:** Allowances were allocated very generously, but during the recession emissions in the traded sector fell well below the over- optimistic projections of economic growth.
2. **Offsets:** Liberal access to international offset credits has further exacerbated this problem.
3. **Market design:** The ETS had no mechanism to correct automatically for the sudden oversupply.

The current low carbon price neither discourages polluting activities, nor does it make investments into low- and zero-carbon technologies more attractive. The surplus of allowances will be carried over to the post-2020 period, allowing European emissions to actually increase over the short- and mid-term. Thus, instead of setting the EU on track towards achieving its long-term goals, the ETS might instead cancel out gains made under our other initiatives on climate and energy.

Solutions:

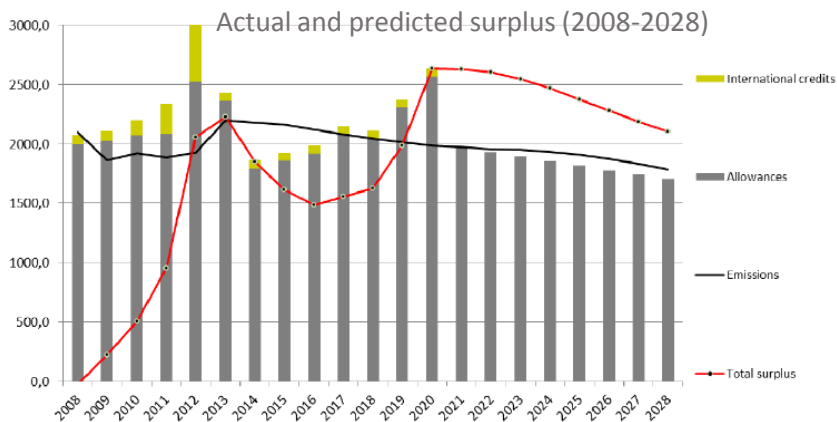
1. **Over-allocation:** Cancel a significant part of the 2.6 billion surplus.
2. **Ambition:** Bring the cap in line with EU's 2°C pathway by increasing the emissions reductions target for 2020 and 2030.
3. **Offsets:** With low prices and falling emissions there is no need for carbon offsets in the ETS past 2020.
4. **Market design:** Implement a Market Stability Reserve at the earliest possible date to protect the scheme against further unforeseen events.

Upcoming:

July - Publication of Carbon Market Watch briefing on the MSR and future ETS reform proposals

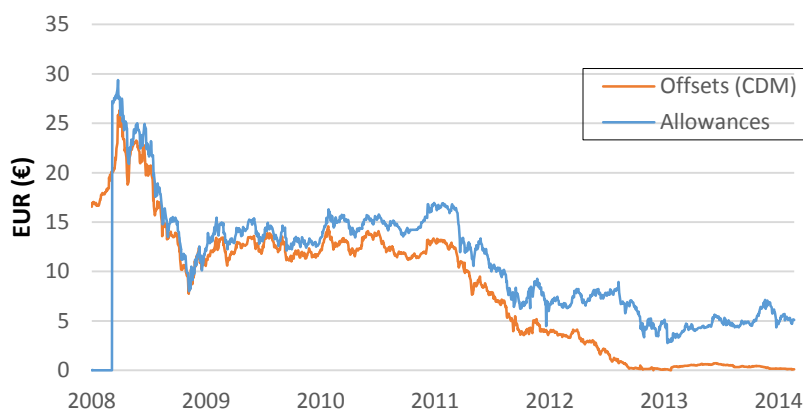
Tuesday 22 July, 15:00 - Q&A session on the EU ETS: Room **JAN 6 Q1**, Brussels.

September – Publication of Sandbag annual report on the state of the EU ETS.



In an attempt to correct for the imbalance of supply and demand under the ETS, the EU has temporarily remove 0.9 billion allowances from auction in 2014-16, to be returned again to the market in 2019-20. This so-called “backloading” is only a temporary measure, as it does nothing to tackle the long-term surplus of allowances.

Trends in allowance and offset price (2008-2014)



The international picture:

Introducing the ETS made the EU a climate champion, but not correcting its structural flaws is eroding our global leadership. 18 similar schemes are implemented or are scheduled outside the EU, including across several US states and Chinese cities or provinces. Many of them, learning from the EU's experience, have already incorporated price stabilization mechanisms.