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Attempts to Reform the EU Emissions Trading System

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The European Parliament has approved the European Commission's proposal to backload allowances in the EU's Emission Trading System. The protracted debate is still unfinished, though, as the issue now passes to the Council. No matter how controversial backloading is, it will have only a short-term, one-off impact on the system. The discussion on structural reforms, though, has already commenced. Major changes are needed, but due to vested and divergent interests, reaching a compromise by 2020 will be very difficult. Poland should advocate solutions that take into account the economic and energy diversity of the Member States and link the debate to the discussion of a 2030 framework for EU energy and climate policy.

The EU Emissions Trading System (ETS), the central instrument of EU climate policy, needs reform. It was devised to promote reductions of emissions of greenhouse gases (GHG) by setting a market price for carbon emitted by highly-polluting industries. In the beginning in 2005, the price of emission allowances were €30 per tonne of carbon, but they have plummeted to less than €3 today. The economic slowdown, improvement in energy efficiency, the higher share of cleaner fuels in the EU energy mix, as well as the accumulation of allowances from previous years, has built up a significant surplus, thus resulting in a sharp decrease in prices. The low prices, in turn, mean that it does not pay off for industry to switch to lower emission fuels or to invest in low-carbon technologies. This undermines the cornerstone tool of EU climate policy. Therefore, the European Commission (EC) has been aiming at reforming ETS. It has proposed short-term solutions, namely backloading, followed by structural changes in the system.

Backloading. Backloading is the EC's initiative to postpone auctioning 900 million emission allowances (from 2013–2015 until 2019–2020), when demand and supply is expected to more evenly matched. Changes in the timetable of the auctions would result in decreasing the amount of allowances thus increasing their prices, and is intended to temporarily improve the performance of the ETS. Such an amendment requires approval by the European Parliament (EP) via the ordinary legislative procedure and by the Council, where the voting will be by qualified majority.

In April, the EP rejected a proposal to amend the 2003 ETS Directive (by a vote of 334 to 315), which allowed for the introduction of backloading. The division ran across the major EP political factions and even divided deputies from certain Member States. Supporters of the reform argued that backloading would stabilise prices and give credibility to ETS. Opponents saw it as public intervention in a market mechanism, arguing that current prices only reflected the economic situation in the EU. The negative vote was received with surprise as for the first time the EP had opposed a proposal on climate policy. The issue returned to the EP's agenda, yet with amendments proposed in the meantime by the EP's Committee on the Environment, Public Health and Food Safety (ENVI). By granting the EC the right to a one-off intervention and addressing the possible negative impacts on industry (in the worst-case scenario, causing industrial production to move outside of the EU, so called carbon leakage), ENVI's modifications indeed facilitated a compromise (although not all of its proposals passed). In a second vote on the issue (3 July), the EP accepted backloading (by a vote of 334 to 311).

Nevertheless, backloading is not in force yet, as it requires the endorsement of the Council. Gaining a required majority there may prove very difficult. The solution proposed by the EC is unacceptable for some Member States as it allows for intervention in the market and a change to the accepted rules. Also significant is the ongoing economic

crisis and the pressure to increase, rather than decrease, EU competitiveness. Backloading may increase the cost of electricity then industrial production costs, risking carbon leakage. EU energy-intensive industries, therefore, are against the solution. On the other hand, many Member States favour EC intervention, claiming that carbon price volatility creates additional risk for investment in the energy sector, while too low a level does not incentivise innovative and low-emission technologies that may increase the competitiveness of the EU economy in the longer term. It is self-evident that firms that have already invested in such technologies support backloading. The final position of some Member States is still unknown, such as Germany, where the discussion was postponed until after the September elections. Given that, it is apparent how deeply the EU is divided over the issue, and the future of this reform is far from clear.

Structural Reform of the ETS. The protracted negotiations in the EP overshadowed the issue of structural reform of ETS. Yet, backloading, no matter how hotly debated, will not prove to be very effective. The EC's own analyses show that the surplus on the market is already at 2 billion emission allowances, so withholding 900 million more will barely affect the market price. With such low prices and an unwillingness to reform the system, the EU not only loses its image as a leader in the fight against global warming but also encounters tangible problems, such as a lack of incentives for the development of low-emission technologies or spreading the ETS model to other regions. Moreover, some Member States have already undertaken independent actions. For example, the UK recently launched a floor carbon price (£16 per tonne), which aims to facilitate achieving the 80% reduction in GHG emissions by 2050. Thus, one may expect the EC to be determined to further support the role of ETS and counteract fragmentation of climate policy. The EC has already given advice on six potential long-term measures to fix ETS, including increasing the EU GHG reduction target for 2020 from 20% to 30%, withdrawing a certain number of allowances permanently, bringing more sectors into ETS or introducing a price management mechanism to be used when the price level is deemed inappropriate. All have one aim—to eliminate a structural surplus of allowances and, as a consequence, to rise prices and increase GHG emission reductions by 2020.

Regarding long-term changes, the EC can count on several countries that succeeded in resuscitating backloading in the EP, including France, the United Kingdom, and possibly Germany. However, other countries, such as Poland and Czech Republic, have consistently opposed reforms allowing the EC to interfere with the supply of allowances or to increase GHG reduction targets. Each solution eventually proposed by the EC will be subject to the normal legislative procedure (involving both the EP and the Council), in which decisions are taken by majority vote, thereby compromise will be difficult to achieve. Because the current terms of the EP and EC expire in 2014, proposals for the reform of ETS will presumably be presented by the new Commission.

Conclusions. The EC, having learnt from the backloading mire, should concentrate on feasible options. Attempts to launch the most controversial proposals, such as a higher GHG emissions reduction target (for example, raising it to 30%), will preclude achieving compromise on ETS reform by 2020. That is why the EC should work on consensus-building, taking into account the diversity (in terms of the national income and energy mix) of the Member States but also prepare an assessment of how such proposals may impact particular countries and sectors of the EU economy. The submitted proposal must also incorporate measures allowing the EU to react to changing economic situations, so as to eliminate the present drawbacks. Poland, which proposes broadening ETS to cover more sectors (for example, transport, where emissions are projected to increase sharply) and taking into account the specific conditions of a nation's energy mix (benchmarks for different fuels), should aim to build a coalition of Member States, staring mainly with Central Europe.

Any changes to the 2020 targets, notwithstanding, in a longer perspective it is essential to integrate the various approaches towards climate, energy and industrial policy, so that their aims and instruments are not conflicting (such as the recent improvements in energy efficiency and the rising share of renewables which have resulted in lower prices for allowances). It will limit the unilateral decisions made by Member States and prevent the disintegration of climate policy and the internal market. In this respect, Poland should advocate for linking the debate on ETS reform with the overall discussion on a 2030 framework for the energy and climate policies that already has been initiated in the EU. A concrete proposal should be discussed, bearing in mind global climate negotiations.