CEPS COMMENTARY
Thinking ahead for Europe

# The EU ETS
# Caught between an ideal and reality

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The EU ETS (emissions trading system) has passed its first decade of operation and has proven to be an inspiration for those who promote carbon pricing through carbon markets as a means to tackle climate change. During this period, Europe has learned important lessons from operating its own ETS and from observing the experiences of other jurisdictions with carbon markets.

Many of us believed that the EU ETS would function in an ideal environment and that no intervention beyond setting a cap would be needed. Slowly, however, reality set in and it became evident that the EU ETS does not operate under the pure conditions found in economics theory. Accordingly, measures were put in place to adapt the EU ETS to the realities of the political and economic operating environment. But have these been enough? Does more need to be done?

Simplistically put, the mission of the EU ETS was to meet environmental constraints in an economically efficient and cost-effective manner. Our recent evaluation of the EU ETS [1] indicates that while the EU ETS has played an important role in the EU, and around the world, in putting a price on carbon through a carbon market, it falls short in some respects. This is especially true in fostering innovation and stimulating long-term investments.

In the real world in which the EU ETS operates, economic efficiency has not been the only constraint, and trade-offs were made between the economic efficiency of decarbonisation and other EU objectives, as well as political priorities and realities. We need to recognise that both decarbonisation and the expansion of renewables are important objectives for the EU.

The Market Stability Reserve (MSR) represents an implicit recognition of the reality of these trade-offs. It was put in place to ensure coordination between overlapping EU policies and to slowly reset the system. Through the MSR, the EU has opted for a volumetric 'corridor' aimed at creating a level of scarcity that it deemed appropriate, and to ensure operational and investment conditions for a low-carbon economy.

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[1] Andrei Marcu, Milan Elkerbout and Wijnand Stoefs, "The State of the EU ETS - 2016", Report of the CEPS Carbon Market Forum, February 2016 (www.ceps-ech.eu/publication/2016-state-eu-ets-report).

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It is now becoming clear, however, that while the tools (e.g. MSR) put in place are a good idea, their design parameters reflect political compromises, and simply do not allow them to be effective in the political and investment timeframes that are necessary to gain acceptability from many stakeholders.

This situation provides grounds for serious reflection of the relative merits of other approaches, which may be needed to prevent the proliferation of national measures, which run counter to the vision of an EU-wide climate policy.

Many such options are being put forward and discussed, some of which include price guidance, which has already been adopted in some North American jurisdictions. It is a solution that raises many questions of principle, as well as practical ones. At the same time, however, it is being put forward, and all options need to be examined to ensure that the EU ETS remains relevant.

If an EU price guidance approach were to be considered, several fundamental features, as presented below, would need to be observed.

- If there is sufficient political will to adopt such an approach, then the price guidance has to be of a significant level in order to motivate action. Otherwise, this would represent yet another political compromise not worth having.
- Market conditions would have to be 're-set', to ensure that the carbon price naturally falls within any price guidance levels that are put forward. If market prices would naturally fall significantly outside any proposed corridor, this would no longer constitute a market.
- Assurance has to be provided that there is effective protection against carbon leakage, but only for those sectors of the economy that are truly at risk. The exposure to carbon leakage should come more from realistic benchmarks, and as little as possible from production levels.
- The use of current tools, such as the MSR or reserve prices, should the first option to operationalise such guidance.