

# The EU Emissions Trading System after 2020: Can the Parliament's Environment Committee achieve its ambitions?

Milan Elkerbout

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The [report](#) of the European Parliament's Committee on Environment, Public Health and Food Safety (ENVI) on the revised EU Emissions Trading System (ETS) for the post-2020 period differs considerably from the European Commission's proposal of summer 2015. Part of the difference may be explained by changes in the global climate policy landscape, most notably the entry into force of the Paris Agreement in November 2016. This CEPS Commentary explores the implications of some of the ideas proposed by the ENVI Committee and reviews the main points of contention.

One of the headline changes is the increase in the linear reduction factor (LRF) from 2.2% per annum, as called for in the European Commission's proposal, to 2.4%. The linear reduction factor is the primary parameter in the EU ETS to effect changes in the cap, and with it the long-term ambition of the policy. It is also a parameter that perfectly fulfils the European Commission's 'desirability criteria' requiring that changes to the EU ETS should be gradual, predictable and based on volume (i.e. supply-side).

An increase to 2.4% results in just under 53 million fewer EU Allowances (EUAs) being available every year, which is less than 5 million more than with the 48 million EUAs proposed by the European Commission. As such, while the impact in the short run is negligible, in the long run, the impact is substantial with the cap reaching zero by the year 2055. This is three years earlier than under the Commission's proposal, and even more significant compared to the current ambition of the EU ETS, under which allowances would be available up to 2068.

Milan Elkerbout is a Researcher at CEPS Energy Climate House.

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This shows the power that minor increases may have in the long term. At the same time, it does little to address the supply-demand imbalance in the short term. To tackle this issue, the ENVI Committee proposes to adjust the parameters of the Market Stability Reserve (MSR),<sup>1</sup> before it has begun to function as originally intended. Specifically, the withdrawal (or absorption) rate would be doubled, from 12% to 24%, although only for its first four years of operation. This doubled rate has a second, indirect and possibly unintended effect. The MSR as agreed so far operates within an ‘operating range’ of 400 to 833 million allowances: above this range, allowances are withheld, and below it they are re-inserted, and within the range, no intervention takes place. However, the 833 million upper boundary was always an implied one, derived from the minimum withdrawal quantity being fixed at 100 million. Doubling the withdrawal rate means that the implied upper boundary drops to 417 million for the four years when the higher rate would apply.

Whether this change is intentional or not,<sup>2</sup> the legislators in any case would do well to reconsider whether an upper range as high as 833 million is appropriate, and whether it would not be better to explicitly fix the upper range instead of deriving it via another parameter. The current range has been established to account for the hedging demand of the power sector.<sup>3</sup> However, with the ongoing structural transition in the electricity market, owing in part to advances in renewable energy and energy efficiency, this hedging demand is also trending downwards. In fact, a mechanism such as the MSR does not require an upper boundary per se; it could just as well function without a range where no adjustments to the supply take place.

### **Sectoral adjustments: New approaches for cement and maritime?**

When the EU decided to extend the EU ETS to international aviation, it initially did not limit its application to intra-EU flights only: any flight either departing from or arriving in the EU would need to comply with the EU ETS. The blowback was immediate. Protests from operators in other countries, as well as their governments, led to a suspension of ETS inclusion for non-EU flights. Nevertheless, the prospect (or threat) of re-inclusion was always explicitly on the table in case no progress was realised for a global approach at ICAO, the UN aviation body. Indeed, ahead of the COP22 in Marrakesh, ICAO agreed on a global market-based mechanism, called CORSIA.

This approach of tentatively including extra-EU sectors or operators seems to have been to the liking of the Members of the Environment Committee. It proposes a similar approach for

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<sup>1</sup> The Market Stability Reserve, adopted in 2015, will introduce flexibility in the supply of allowances by adjusting the auction levels based on the total number of allowances in circulation. It will start operating from 2019 onwards.

<sup>2</sup> [www.ecofys.com/en/blog/the-eu-ets-review-current-state-of-play/](http://www.ecofys.com/en/blog/the-eu-ets-review-current-state-of-play/)

<sup>3</sup> [www.diw.de/de/diw\\_01.c.465890.de/presse/diw\\_roundup/can\\_the\\_market\\_stability\\_reserve\\_stabilise\\_the\\_eu\\_ets\\_commentators\\_hedge\\_their\\_bets.html](http://www.diw.de/de/diw_01.c.465890.de/presse/diw_roundup/can_the_market_stability_reserve_stabilise_the_eu_ets_commentators_hedge_their_bets.html)

the maritime sector, while also de facto singling out the cement sector for a new approach to carbon leakage risk mitigation that is aimed at importers.

The maritime sector's proposed inclusion is particularly reminiscent of the aviation sector's approach. The amendment expressly mentions that the sector's inclusion will only go ahead in the absence of a "comparable system operating under the IMO" (International Maritime Organisation). If this is considered to be the case – a purely political decision – then all ships arriving at, or departing from an EU port would have to comply with the ETS.

However, maritime operators would have the option of not surrendering allowances, but instead paying into a 'Maritime Climate Fund', which would surrender allowances on behalf of the operators paying into the fund, but also fund initiatives in energy efficiency and innovative technologies. Perhaps unsurprisingly, the international response was dismissive towards the EU's increased ambition for the maritime sector, with the secretary-general of the IMO expressing his dismay to the EU institutions.

While EU member states such as Greece, with large maritime sectors, may see the proposed inclusion differently, the Committee's plan shows that MEPs are not afraid of aggravating trading partners and will continue to favour unilateral action in the hope of spurring others to do more.

A different rationale underpins the proposed 'import inclusion mechanism', which would specifically target sectors with low trade intensity, but which are nevertheless considered at risk of carbon leakage. Under this mechanism, importers in such sectors would be required to acquire and surrender EUAs. EU operators in these sectors would then no longer receive free allowances, but would need to acquire EUAs through auctions or the secondary market. The criterion for inclusion in this new carbon leakage risk mitigation measure would be sectors with a trade intensity of 10% or below in the 2009-13 period.

In practice this means that the new mechanism would be targeted at the cement and lime sectors. These are both sectors with a trade intensity well below 10%, whilst still having very high emissions intensity. It also regards sectors, which together account for a sizeable share of total industrial emissions and free allocation. In 2015, emissions in the cement sector were over 100 million, about 16% of total industrial emissions (excluding the power sector and aviation). The cement sector also received just under 1/5<sup>th</sup> of all allowances allocated for free to industrial sectors. The lime sector, while significantly smaller, still accounts for about 1.5% of total emissions in the EU ETS.

Hence, with a total of about 150 million allowances that would be auctioned, not freely allocated, the pressure on other industrial sectors that compete for these allowances would be alleviated. This is particularly important as the number of allowances available for free allocation will only decrease over time. While for the period up to 2030 the free allocation system can still suffice, possibly again with the help of a cross-sectoral correction factor, after 2030 the 'pie' will likely have shrunk to an extent that this becomes less feasible. This is all the

more so the case if the EU ups its ambition in response to the Paris Agreement 5-year review cycles.

Some questions, nevertheless, remain about the feasibility of such an import inclusion mechanism. First, by nature, such a mechanism only targets importers, while exports<sup>4</sup> by EU producers would still compete with producers not facing comparable carbon constraints. The protection offered is therefore different in character than that offered by free allocation. Secondly, just as with the aviation and maritime sectors, unilateral EU action that affects producers/operators outside the EU may lead to resistance in those countries, and comes at a political cost. Potential retaliation may be a particularly salient consideration given the incumbent in the White House. Thirdly, the compatibility of the mechanism with WTO rules will need to be ascertained, which may limit the design choices available.

What speaks in favour of the import inclusion mechanism is the fact that auctioning is supposed to be the default method of allocation in the EU ETS. Free allocation was always intended to be a transitional measure and a temporary derogation from this rule. The proposed mechanism allows a major industrial sector to return to auctioning as the default method of acquiring allowances, while still being guarded against carbon leakage risk. Whether this protection is sufficient is largely a political decision, as carbon leakage *risk* is difficult to measure, with little agreement on the adequacy of proxies such as emissions and trade intensity that are currently used to measure this risk.

## Benchmark updates

At the core of the Commission's proposal are the annual reductions in the benchmark values. With a standard rate of 1% per year, and derogations of 0.5% in either direction, sectors would see their free allocation decrease by 10-30% over the course of Phase 4. The ENVI report moves towards more flexibility for these flat-rate reductions, by increasing both the lower and upper limits to 0.25 and 1.75% respectively.

This change can have significant consequences for the distribution of allowances to industrial sectors. Under the European Commission proposal, the flat-rate benchmark reductions play a major role in avoiding the cross-sectoral correction factor. If all sectors would fall under the standard rate of 1%, free allocation would decrease by 17.5% between 2020 and 2030, a number that is perhaps not coincidentally similar to the impact of the correction factor in 2020. According to the modelling conducted for the Commission, this gives a high likelihood of not triggering the correction factor, or limits its application to the very end of the trading phase.<sup>5</sup>

Even with the derogations to 0.5% and 1.5%, the Commission proposal only had three different rates that could apply. The ENVI report, however, not only extends the range within

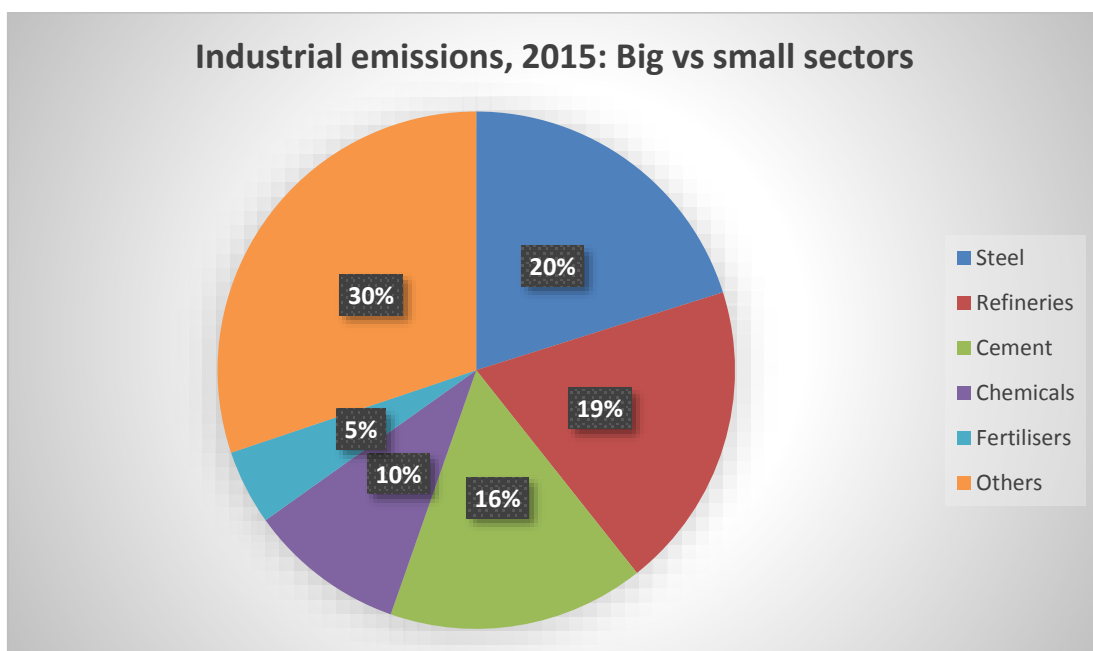
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<sup>4</sup> The export value of Portland cement accounted for 6.7% of total production in the EU in 2015 (Eurostat PRODCOM).

<sup>5</sup> [https://ec.europa.eu/clima/sites/clima/files/docs/0111/conclusions\\_en.pdf](https://ec.europa.eu/clima/sites/clima/files/docs/0111/conclusions_en.pdf)

which the updates could fall, but also switches to 'real' values, meaning that if a sector improved its efficiency compared to the reference period by a given percentage (say, 0.87%), this exact number would be used to update the benchmark. As a result, the Committee's report sacrifices some predictability for an increase in accuracy and flexibility.

Given how concentrated industrial emissions and free allocation are in just a small number of sectors, different benchmark updates values will significantly alter both the likelihood and the impact of a cross-sectoral correction factor during Phase 4. To illustrate, the three largest industrial sectors (steel, refining and cement) in terms of emissions are together responsible for about 55% of total industrial emissions. Even a 0.1% difference in the annual benchmark reduction would translate into millions more of allowances being needed for free allocation, which may again trigger a correction factor.



*Source: Author's own calculations, based on EUTL data published by the European Commission.*

Even if a correction factor in Phase 4 is likely to be lower than during Phase 3 (where it was applied from 2013 onwards, starting at 5.7% and rising to 17.5% by 2020), the ENVI Committee nevertheless aims to avoid it completely by a conditional reduction in the auction share, which would result in an additional 5% of total allowances being available for free allocation. In case a lower amount than 5% is required to satisfy the free allocation demand from carbon leakage risk-exposed sectors, the 'leftover' allowances would be cancelled up to a maximum of 200 million EUAs.

Such a reduction in the auction share undoubtedly reduces the impact of a potential correction factor, but it remains to be seen how this reduction in auctions, which would come at the cost of auction revenues to governments, will be received by member states. While some, like Belgium, have always backed a recalculated, and lower, auction share, many member states in Central and Eastern Europe are protective of the contributions of auctions to their national budgets, and may push back at seeing them reduced.

A similar issue may arise with a proposed fund to address indirect carbon costs. Currently, these costs – which arise from the pass-through of higher electricity costs to industrial consumers – may be compensated at the discretion of member states, and subject to environmental state aid rules. The ENVI Committee proposes to pool 3% of auction revenues instead, and use the generated funds to compensate for indirect costs in a harmonised way. This again may not be to the liking of member states that attach a premium to fiscal sovereignty.

## Conclusion

The ENVI Committee's position would increase the ambition of the EU ETS compared to the original proposal of summer 2015. However, this Committee's position is likely the most ambitious of the legislative actors involved. The proposal will still need to pass the plenary in the European Parliament, and the Council of Ministers is yet to form their position before a compromise will have to be reached in 'trilogue'. As such, the final outcome of the EU ETS revision may be more modest in its ambition. The question of ambition in the EU ETS is likely to be a mainstay of EU climate policy discussions, as implementation of the Paris Agreement advances.