



Frequently Asked Questions about the Emissions Trading System reform

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The reform of the EU's Emissions Trading Scheme (ETS) for the period from 2021-2030 is currently being discussed in the European Parliament and the Council. The following should help you find answers to some of the most frequent and urgent questions in this debate.

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Is the ETS working as a “flagship” climate instrument?

No, and here is why:

The ETS sets a limit on the amount of greenhouse gas emissions that can be emitted. Companies covered by the ETS receive or buy pollution permits – called EU emissions allowances. One EU allowance allows for one tonne of CO₂ to be emitted. The ETS aims to help the EU achieve its emissions goals more cost-effectively and to catalyze investments in energy efficiency and renewable technologies. The ETS cap becomes slightly more stringent every year so that total emissions decline over time to minus 21% in 2020 and to minus 43% in 2030 from 2005 levels. (See [Carbon Market Watch's Intro to the ETS](#) for more info).

Despite being hailed as the flagship of European climate policy, the EU ETS has failed to deliver adequate emission reductions and a meaningful carbon price. The 2020 and 2030 reduction targets are completely out of step with the Paris Climate Agreement, where all countries agreed to hold the temperature increase well below 2°C and furthermore to pursue efforts to limit it to 1.5°C.

A weak reduction target and the massive use of international offsets have led to the build-up of an enormous surplus of over 3 billion allowances. The price of pollution permits in 2016 again fell to less than 4 Euros. The reforms that have been passed so far or proposed under the current revision are nowhere near enough to fix the ETS.

What would have to be done to make the ETS work?

What matters to the climate are the total cumulative emissions to the atmosphere. This is what is called the carbon budget. The proposed carbon budget for the ETS until 2030 is hugely inflated! Sandbag and others predict that the ETS will remain oversupplied (meaning have more pollution permits than emissions) until 2030 if the current proposals on the table are not significantly strengthened. The total number of allowances that will be available 2021-2030 needs to be dramatically reduced if we want the ETS sectors to rapidly decarbonize. This can be achieved by:

Cancellation of all surplus that will have accumulated by 2020

[Sandbag's new analysis](#) of European emissions in 2016 reveals that the EU ETS has hit a record of **3 billion tonnes of surplus allowances** and this surplus will grow further until the end of 2020 [to about 3.5-4.4 billion](#). Under current rules this surplus can be fully carried over to the next trading period and therefore inflates the ETS's carbon budget by billions of tonnes (see dark blue area on the graph below)!

A word about the Market Stability Reserve

To address the oversupply and create a more stable price, EU policy makers agreed in 2015 to establish a Market Stability Reserve (MSR). It will start in 2019 and will temporarily withhold part of the surplus from the market and will bring it back when available allowances go below a certain level. Although a welcome policy tool, it is unclear how effective the MSR will be in practice. What is worse, the MSR does not permanently remove any of the surplus. [According to Sandbag](#), by 2030 the MSR will contain 3-5 billion tonnes with some surplus still available to market.

Lowering the starting point for 2021 to actual emission levels (rebasin)

The cumulative emissions budget is determined both by the starting level in 2021 and the end point in 2030. The starting point for 2021 should be at actual emissions and not at the current minus 21% ETS target for 2020. If the emissions will be, as projected, at minus 38% in the ETS sectors by 2020, starting at actual emission levels would significantly reduce total emissions under the ETS. The starting point should be based on average emissions from 2017-2019. This would eliminate up to [2.4 billion tonnes of surplus](#) compared to the Commission's proposal, depending on where actual emissions will be in 2017-2019 (see dark green triangle in figure below).

Raising the Linear Reduction Factor

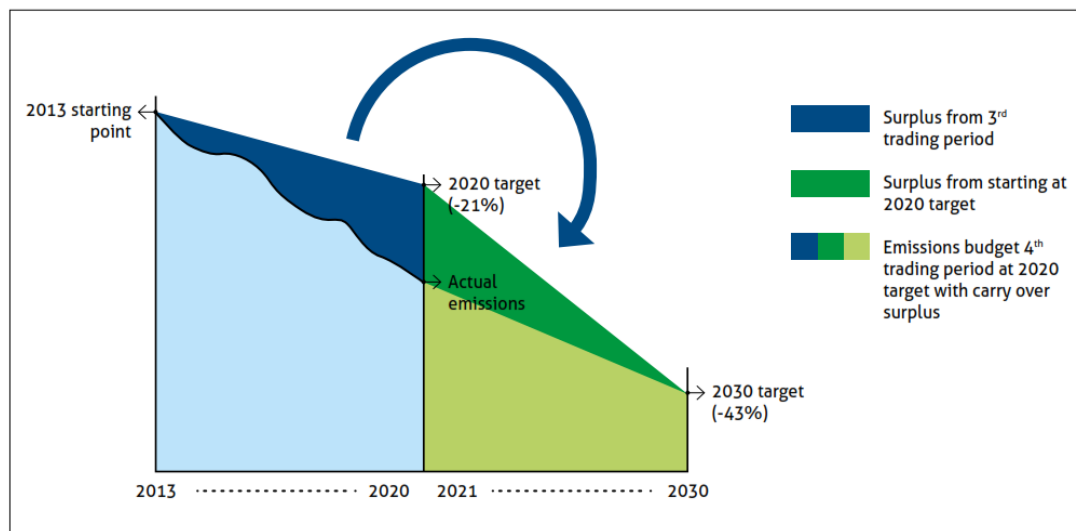
The Linear Reduction Factor (LRF) determines by how much the number of available allowances are reduced every year. The proposed LRF of 2.2% for the period from 2021 to 2030 was set in the Council Conclusion of 2014, long before the Paris Agreement. It is too low according to the [Commission's own Impact Assessment](#) from 2014. It would lead to ETS reductions by 2050 of only 84% compared to 2005. The LRF should be raised to at least 2.8% together with all other measures mentioned here.

In summary

In order to get the ETS to deliver emission reductions we need to: 1) cancel the surplus (dark blue area), 2) lower the starting level to actual emissions in 2020 (which eliminated a new surplus, see dark green rectangle, 3) raise the LRF to at least 2.8% (not shown in the graph, it would have made it too complicated) and 4) include a revision clause that ensures the ETS is revised regularly and can be brought in line with Paris goals.

There are many other things that need to be reformed about the ETS, such as ensuring that all allowances are auctioned and not given for free to polluting industries, that no auctioning revenues are used to fund coal or other fossil fuel projects, etc etc, [see our full position](#). **The number one priority though is to ensure the ETS works for the climate.**

Illustrative graph of Phase 4 ETS emissions budget



What is in the ENVI reform proposal that will be voted on in the European Parliament on Feb 14th 2017?

Overall there are some improvements compared to the Commission’s proposal but these fall short considerably from turning the ETS into a functioning tool. There are many important decisions in the ENVI report but we focus here on the two topics only: raising of ambition and limiting free allowances to industry.

800 million pollution permits from the MSR cancelled

This is a good gesture but it is merely a start. The proposed cancellation from the MSR will not have an impact on the price until 2030 because these allowances would not have come back to market until 2030 anyway. (According to Sandbag, the MSR will contain 3.5 – 5.4 billion by 2030 and it only returns 100 million tons per year.) In other words, the effect of the cancellation will be felt only in 30 years’ time, by which time the world will likely have passed the 1.5C temperature increase the Paris agreement was designed to avoid.

Linear Reduction Factor raised from 2.2% to 2.4%

Increasing the Linear Reduction Factor (LRF) to 2.4% has only a minor impact on the market before 2030: a surplus decrease of 242 million tonnes during Phase 4.

But the raise of the LRF is nevertheless a very important improvement because it goes beyond the guidance in the October 2014 European Council Conclusion. So it has important symbolic value and sends a strong message to the Member States that the European Parliament is ready to go beyond the Council Conclusion and the Commission’s proposal neither of which are in line with the Paris Agreement.

Take out rate of the MSR doubled for four years (2019-2021)

The doubling of the withdrawal rate of the Market Stability Reserve for the first four years of its operation, as adopted by the vote in ENVI, will not significantly change the situation by 2030 due to the way its parameters were set up. The surplus will be endemic until after 2030. The Commission and Parliament have so far proposed no adequate fix for this.

Setting the starting level at actual emissions (rebasings) was rejected by ENVI

We expect this idea to be reintroduced for the vote in plenary on February 14th. It will be especially vital to rally support around this amendment, as it would remove a big chunk of surplus, see above.

Share of auctioned allowances decreased

The auctioning share was decreased from 57% by a maximum of 5% to 52%. This is not what we want because all polluters should be paying for their climate impacts and not be given free allowances, see more below.

More targeted carbon leakage protections

Cement and a few other sectors will potentially become excluded from carbon leakage list. An import inclusion scheme introduced for all sectors with trade intensity below 10% in 2009-2013. This is an excellent amendment, see more below.

How do European industries profit from the ETS?

Since 2013, power companies are obliged to buy all of their CO₂ allowances at auction. However, under the current rule, the ETS hands out free emission allowances to energy-intensive companies deemed at risk of “carbon leakage”. “Carbon leakage” refers to the hypothetical situation where companies transfer their production, or parts thereof, to countries with weaker climate policies to lower their production costs. So far, there has been no evidence for carbon leakage in the EU. This is why the free emission allowances represent subsidies to industry while governments forego income and lose out on the revenues that they would earn from auctioning these pollution permits.

Furthermore, when too many free allowances are handed out, companies can make a windfall profit from selling these surplus allowances.

As research shows, **heavy industry in Europe was able to make over €25 billion in windfall [profits](#) from the EU ETS between 2008 and 2015**. Most profits were made in Germany, the United Kingdom, Spain, France and Italy.

European taxpayers are picking up the bill as governments forego income from auctioning. In the 2008-2015 period, governments have given out 11.8 billion free pollution permits and have thereby missed out on **at least €143 billion** in auctioning revenues, see below.

Giving away free allowances reduces the incentive for companies to produce more efficiently and to invest in the development of low-carbon, climate friendly technologies. Unless this changes, emission reductions in Europe will stall over the next 15 years. A change of rules of the ETS is therefore urgently needed to make European industry competitive as well as climate-friendly.

Why does the cement sector oppose the ENVI proposal?

The cement sector has been one of the biggest beneficiaries of the ETS - **profiting by almost €5 billion from free allocation of emission allowances between 2008 – 2015**, profits that they would no longer be able to make if the current rules for free allocation changed.

At the same time, the **cement sector is one of the biggest polluters**. It is responsible for 5% of global GHG emissions. In Europe, the cement sector alone emits more GHG emissions than the whole Belgian economy. Under the current ETS rules, the sector has failed to reduce its emissions.

The European Parliament Environment Committee has adopted a set of compromises to fix the current rules. Among other things, the ENVI report proposes to remove free allocations for cement and other industrial sectors that do not have a trade intensity above 10% and to instead establish an **import inclusion scheme** requiring European importers of these products to buy EU emission allowances.

The ENVI proposal introduces a level-playing field while at the same time being WTO-conform. This means the cement sector will be protected from the risk of carbon leakage while receiving the long overdue incentive to decarbonize. Not surprisingly, the sector opposes the idea, since it will mean the end of free overallocation and therefore the end of windfall profits from overallocation.

How can Member States profit from the ETS?

Reducing carbon pollution means lower health bills, cleaner air and smaller risk of climate change damage. In addition, Member States stand to make a direct financial gain from a properly reformed ETS, which can be used to further accelerate the energy transition. This is because the money raised from auctioning emissions allowances goes to EU countries. The higher the carbon price, the higher the revenues.

Countries got €12 billion from ETS revenues from 2013-2015, WWF's EU-funded MaxiMiseR project [found](#). They reported they've spent 85% of this in climate-friendly ways, like on renewable energy projects.

But [MaxiMiseR](#) also calculated that if the ETS was properly fixed - by more surplus allowances being removed from the market every year and free allowances being gradually phased out - EU Member States could potentially raise as much as €120 billion in auctioning revenues from 2021-2030.

And if this money was fully allocated to climate action - as the European Parliament has proposed - it would become a major and crucial source of financing to help Member States make the transition to a zero carbon Europe by 2050.

Why is the ETS not enough?

A short blog on [Why a price on carbon cannot fix everything](#) which has links to further info on the need for many different and complementary policies.

Do other policies undermine the ETS?

[Sandbag wrote a recent briefing](#) on debunking the (only very partially true) argument that when one country does more it just leads to another having to do less.

Why should aviation and shipping be included in the ETS?

Aviation and shipping are responsible for over 7% of EU's emissions and their emissions are growing. Their fuel is tax free, resulting in lost revenue for member states and undermining incentives to decarbonise. CO2 emissions from European ships are on a par with total emissions of the Netherlands, ranked emitter #7 in the EU.

To date action at international level has been wholly insufficient with only a weak and voluntary measure emerging from ICAO, the UN aviation agency. Despite several missed deadlines for EU action, shipping remains the only sector not required to undertake measures to contribute to economy-wide decarbonisation efforts.

Inclusion in a reformed EU ETS will ensure that both of these sectors, like every other sector of the European economy is required to make a fair contribution to Europe's climate efforts. Action at European-level is likely to stimulate greater ambition at international level, creating bottom-up momentum for global action. Failure to act now and include these sectors in a reformed EU ETS risks another decade of inaction.