European Council

Reviewing the EU Emissions Trading System to realise net-zero carbon emissions

Research Report

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Introduction

The EU Emissions Trading System was introduced in 2005 as an initiative to reduce the overall emission of greenhouse gases to prevent the worsening of the climate crisis and aim to resolve it. Since then, emissions have been cut by over 42% in sectors covered by the system, namely power and heat generation, energy-intensive industrial installations and aviation within Europe. Most of the cuts have been made in the power sector since the market-based nature of the system ensured reductions where they are easier to introduce. The system is based on a cap-and-trade approach, which has many advantages but also can be taken advantage of, an example of which would be carbon leakage.

Definition of Key Terms

ETS:
The EU Emissions Trading System.

CO2 equivalent:
Carbon dioxide equivalent or CO2e means the number of metric tons of CO2 emissions with the same global warming potential as an amount, such as one metric ton, of another greenhouse gas.

Energy-intensive companies:
Companies that use large amounts of energy, such as the cement industry.

Carbon leakage:
Carbon leakage is an environmentally dangerous process during which European countries whose energy costs are too high decide to relocate to countries outside the EU, where regulations are less strict, thus gaining the opportunity to produce more CO2 equivalents.

Cap-and-trade:
The cap-and-trade approach to reducing greenhouse gases is based on the idea of limiting the amount of greenhouse gas that can be emitted in a year (this is the "cap") and allowing companies, plants etc. to trade their allowances amongst each other.

Net-zero carbon emissions or carbon neutrality:
Carbon neutrality is a state of net-zero carbon dioxide emissions. This can be achieved by balancing emissions of carbon dioxide with its removal or by eliminating emissions from society.

General Overview

As stated before, the aim of the ETS is to gradually reduce carbon and other environmentally harmful chemical emissions, ideally to the point of net-zero carbon emissions. This is achieved using the cap-and-trade approach, cap referring to the maximum amount of emissions to be used during one year. If a company, for example, has allowances remaining at the end of a year after having surrendered allowances of the equivalent value of their emissions that year, they have the opportunity to use them the next year or to sell them to other entities, thus the "trade" part. In case the company does not have enough allowances at the end of the year, they have four months to buy them from another company, otherwise, they have to pay a fine, since the ETS is based on legally binding agreements. The Market Stability Reserve, operating since 2019, ensures the stability of the market by removing excess allowances from it.

Even though a clearly thought-through system with many advantages and great ambitions, the EU ETS has its faults and limitations. Perhaps the most important one is carbon leakage, meaning that entities who find it too costly to keep up with carbon emission regulations relocate to countries where rules are less strict or less strictly enforced. Critics of the system have also stated that by only gradually reducing emissions over the course of decades, the EU ETS "sets a ceiling on climate ambition." The intangible nature of carbon emission allowances makes the trade of this "product" especially susceptible to fraud, which is very hard to control. Free allowances are also highly problematic, which is why they are being gradually eliminated.

In July of this year, a legislative proposal was introduced with the aim of cutting emissions by at least 55% compared to 1990 by the year 2030. The contribution of the EU ETS to achieving this goal is crucial since the sectors covered in the system account for 41% of the total emissions of the EU. The Commission proposes to cut the emissions within the sectors covered in the EU ETS by 61% compared to 2005, when the ETS was introduced, through the following means:

- Raising the current 2.2% annual emission reduction to 4.2% per year;
- Implementing a one-off reduction of the overall emissions cap by 117 million allowances;
- Gradually removing free allowances for the aviation sector to move to full auctioning of allowances by 2027;
- Strengthening the MSR;
- Covering more sectors in the EU EST, and where needed, creating a separate system that functions in the same way.

Households and factors affected by these changes have to be protected, of course. For this reason, the Commission proposed in 2021:

- Making more funds available for switching to innovative and more environmentally friendly solutions;
- Increasing the size of the Modernisation Fund by 2.5% allowances from the total quantity;
- Setting up a new Social Climate Fund to address social impacts of the extension of emissions trading to road transport and buildings on vulnerable households, micro-enterprises and transport users financed by the EU budget.

The aviation factor and maritime transport will also be included in reforms since they contribute heavily to CO2 emissions. The actions taken in these fields towards a carbon-neutral future were also covered in the 2021 amendments by the Commission.

The Commission also proposed some solutions to issues the EU Emissions Trading System has currently:

- Free allowances will remain a tool to protect against carbon leakage until at least 2030, but the Commission proposes to start reducing the amount of these in the second half of the decade;
- The stability of the market is ensured by the Market Stability Reserve, which was proposed to operate in the new emissions trading system for road transport and heating fuels, with specific rules.

Major Parties Involved

The Countries of the European Union

The EU has 27 member states, which are all, naturally, part of the European Union Emissions Trading System, meaning that all legally binding agreements apply equally to each of them.

EEA EFTA States

The three such countries are Iceland, Liechtenstein and Norway. These states are not part of the EU itself, yet based on the EEA (European Economic Area) Agreement of 1994 the EU and the EEA EFTA states are joined into one market with the same basic rules, referred to as the "Internal Market."

Developing Countries

In multiple developing countries, both African and in Asia, we can observe strong nationalist movements. This, in combination with the general nationalist spirit globally as well as along with their underdevelopment and the poor living standards of their people, only tenses the global situation.

Market Stability Reserve

The MSR is an organ responsible for removing surplus allowances from the market, thus stabilising it. The Market Stability Reserve has been in place since 2019.

Timeline of Events

1994	The EEA agreement enters into force
2005	The introduction of the EU Emissions Trading System
2021	The European Commission adopted a series of legislative proposals with the aim of achieving carbon neutrality by 2050
2030	The target set in 2021 is to reduce carbon emissions by at least 55% by this year compared to 1990 levels
2050	The year when the EU hopes to reach net-zero carbon emissions

Possible Solutions

It is definitely difficult to balance the number of free allowances and the cuts made over time regarding overall allowances, especially taking into consideration the need to simultaneously counter carbon leakage and corruption, therefore the EU ETS requires further reviewing.
One proposal interesting to examine is the Carbon Border Adjustment Mechanism (CBAM). This is a tariff that would be implemented inside the European Green Deal with the main aim of shielding Europe's steel, cement and aluminium sectors from imported goods that may have a lower price, but the difference is paid for by the environment since they are produced under less eco-friendly conditions with looser restrictions. According to the CBAM, importers would be forced to buy carbon allowances themselves. Possible issues have to be considered, though: the agreement of all 27 EU Members are needed to implement this initiative, and World Trade Organisation rules cannot be neglected either.

Sources and useful reading:

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