Repair emissions trading – rescue emissions trading!

by Felix Chr. Matthes

The situation is paradoxical. While in California, Australia, South Korea and China ambitious emissions trading schemes are gathering pace, the EU Emissions Trading Scheme is lurching into its deepest crisis yet because European policy is trapped in stasis.

The EU Emissions Trading Scheme (EU ETS) is supposed to initiate a competitive process in which the most efficient options for capping carbon dioxide (CO_2) emissions are identified and a corresponding CO_2 price enables all actors to decide to implement their own emission reductions or purchase additional allowances – in effect, to act efficiently.

This requires that the number of available emission allowances is below the emission level expected without the CO_2 price – only scarcity generates a price. There is no longer such a scarcity in the EU ETS for two reasons. Firstly, due to the financial crisis in Europe economic activity will be, in the very long term, 15-20 per cent below the level which was taken as a basis for the EU ETS in 2007. Secondly, the EU ETS has been flooded by a huge number of allowances from countries outside of Europe; with prices currently at a few cents, there can no longer be any illusions about their value in terms of the reduction of greenhouse gas emissions. In contrast the expansion of renewable energies is not a driver of the crisis – contrary to statements that have been made. The effect of this expansion on the reduction of CO_2 emissions in the EU takes the exact same path as that on which the emission targets for 2020 were set.

The surplus now amounts to more than two billion emission allowances, which approximately corresponds to the annual emissions of all installations covered by the EU ETS. This lack of scarcity will continue for at least the next ten years. And if the plan to incorporate air transport effectively in the EU ETS fails, the demand for an additional 500 million emission allowances does not apply, with the result that the carbon market would contain substantial surpluses for a period far beyond 2025.

That current CO_2 prices have not yet reached zero, can only be explained speculatively. Several market participants stockpile cheap allowances so that they can sell them over a decade later. However, the sharp erosion of the CO_2 price in recent days and weeks – especially after adaptation measures were rejected by the Committee on Industry, Research and Energy of the European Parliament at the end of January 2013 – shows that there has been a huge rise in risk premiums for these highly speculative investments due to policy remaining hamstrung. In the final analysis an instrument that has been ailing and ineffective for at least 15 years cannot be kept up and running.

Europe is at the beginning of an urgently needed investment cycle, most notably in the energy industry. Without a price signal for CO_2 that is scarcity-based and thereby reliable for investors of the real economy, there is investment restraint or investments are made in CO_2-intensive infrastructures – with consequential costs that are high in the long term. As a result countries tend to adopt a "go-it-alone" approach, from carbon taxes via emission standards to increased pressure to introduce capacity markets and other financing mechanisms – all measures which are by no means without cost. This is also another reason for the energy industry above all supporting a revitalization of the EU ETS.

In order to solve the crisis, its fundamental cause – the huge surplus of emission allowances – has to be eliminated. This is only possible if action is taken on a number of levels. The current proposal of the European Commission to allow the backloading of new emission allowances would constitute a first step towards demonstrating the ability of policy to take action in this area and a will to retain the EU ETS. Time could also be gained for further steps. These steps can and must be to take backloaded allowances out of the market for a long period of time and to anchor the (in any case necessary) adaptation of long-term EU emission reduction targets in the scheme.

At the end of the reform there has to be a set of regulations that precisely define the adaptations' scope for intervention in the CO_2 market. Only with such a combination of short- and long-term measures can the EU ETS be effectively repaired and the instrument rescued.

However, in the extremely polarised conflict about the stepwise reform of the EU ETS, many opponents of reform are concerned less with the instrument than with attacking climate policy itself. Yet in reality climate policy will continue, even if the EU ETS becomes ineffective and is no longer used. Climate policy will simply become less European and less transparent, more inflexible and in the end probably more expensive for all sides. And that is something of which the opponents to reform, the Industry and Energy Commissioners in Brussels, the Economics Minister in Berlin, the government in Warsaw, the lignite power plant operators, the chemical, aluminum, copper and steel industries as well as its allies should all take note.

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