Emission Trading beyond backloading

Energy and Climate Exchange, Bruegel, 23 May 2013

After the European Parliament decided to - for the time being - stay away from backloading, the discussion on reforming the Emission Trading System (ETS) continues. A number of short-term fixes and long-term measures to re-establish the ETS as the centerpiece for synchronizing decarbonisation in the EU (and beyond) are on the table. In this panel-discussion we discussed the merits of several approaches.

First, PBL's study was presented. This evaluates the measures the Commission proposed to solve current issues with the ETS. The study notes some of the anomalies of the CO2 market and suggests that ETS could work well, as it is a very powerful tool to reduce information asymmetries and to create a new menu of options. In the study, four reform measures are evaluated: (i) a cap adjustment (a permanent set aside could be more effective than simple backloading), (ii) an expansion of the scope of the ETS to other sectors, (iii) a discretionary price management mechanism and (iv) a combination of ETS with a carbon tax. They are all somewhat effective in reducing emissions and increasing the carbon price, with the most effective being increasing ETS target (-8.5% GHG emission compared to the reference scenario).

Georg Zachmann presented a possible approach to re-establish confidence in the ETS in the short-term. First, the ETS performed very well in his opinion. A surplus of allowances has arisen. A possible explanation for the subsequent price slump is a lack of confidence in the system. This could be very dangerous for the political sustainability of the system. Thus, an insurance device could be a feasible and effective tool. It should work as a long-term commitment device, with which a public institutions such as the EIB sells guarantees to hedge investors against carbon price drops. This measure would be effective in restoring confidence and also in giving time to think of more structural reforms for the ETS.

The discussion then continued by highlighting how other competing policies overlap with the ETS, and that there is no control of such policies. In addition, backloading would only be a short term measure (as soon as allowances are re-introduced on the market, prices would drop again). Also, there is a need for a predictable intervention framework, and a credible constraint which takes into account policy complementarity. An ETS target corridor has to be defined and an independent carbon market authority should be in charge of preserving the good functioning of the market, and consistency with other policies.

Moreover, three important issues were underlined: first, the current situation with the ETS is a strong imbalance in the market. This leads to the second issue, i.e. how to tackle this large surplus. Finally, how can the ETS rules be changed to solve this imbalance, and to avoid having similar problems in the future? Stakeholders seem to have a preference for measures that do not involve a direct action on the prices, and this is the main reason why ETS was deemed a better instrument than price regulation.

In this framework, backloading should be encouraged as a short term measure that gives more time to effectively reform the ETS. More long-term interventions may involve a change in the linear factor reduction of allowances, a tightening of the target, a more flexible supply and an extended ETS coverage.

Q&A: From the point of view of some, the main issue is the external competitiveness of European firms compared to those in the rest of the world. In this scenario, it was underlined that there have been more and more commitments for carbon related policies around the world, following what the EU is doing with the ETS. Other interesting observations concerned the reason for overlapping policies in the first place and the link of the ETS with real economy.

Event notes by Alice Gambarin and Michele Peruzzi