Scheme for greenhouse gas emission allowance trading within the Community. EU Emissions Trading System (EU ETS) Directive

2001/0245(COD) - 17/12/2018 - Follow-up document

In accordance with Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading within the Community (ETS), the Commission presents a report on the functioning of the European carbon market for 2017. It also presents initiatives proposed or agreed in the first half of 2018.

The EU Emissions Trading System (EU ETS) contributes significantly to the achievement of the EU's target of cutting greenhouse gas (GHG) emissions by 20% from 1990 levels by 2020. While the EU is on track to surpass this target, cutting GHG emissions by at least 40% by 2030 – as part of the EU's 2030 climate and energy policy framework – requires continued progress. A well-functioning EU ETS constitutes the main mechanism to achieve the EU's 2030 target, by facilitating a decrease of 43% of GHG emissions compared to 2005 levels in the sectors covered by the system.

Legislative changes

After extensive negotiations, the revised EU ETS Directive reforming the system for the next decade, entered into force on 8 April 2018. The revised Directive for phase 4 aims to facilitate the achievement of the threefold objective of a 43% GHG emissions reduction for EU ETS sectors by 2030, safeguarding industrial competitiveness, and fostering low-carbon modernisation and innovation by a series of interlinked measures.

To increase the pace of emissions cuts, the overall number of emission allowances will decline at an annual rate of 2.2% from 2021 onwards, compared to 1.74% currently. This increase implies a steady reduction of some 48 million allowances annually, compared to 38 million currently, and is consistent with a 43% reduction in GHG emissions from ETS covered sectors by 2030, compared to 2005 levels.

In 2017, the EU ETS Directive was further revised to accommodate the development of a global measure for reducing aviation emissions by the International Civil Aviation Organisation (ICAO), by continuing to keep the systems' coverage confined to flights within the European Economic Area (EEA).

2017 also marked the signature of an agreement between the EU and Switzerland on linking the Swiss greenhouse gas emissions trading system to the EU ETS - the first such agreement for the EU.

Following the adoption of the revised legislation, the focus has now shifted towards implementing the new provisions ahead of the start of phase 4. Implementation work, in particular on carbon leakage and free allocation, as well as on the Innovation Fund is in full swing.

Progress on emissions

In 2017, emissions from installations covered by the European Emissions Trading System (EU ETS) increased slightly by 0.18% compared to 2016. While this breaks the decreasing emissions trend since the start of the system’s third trading period (2013- 2020), it can be explained by growth in real GDP of 2.4%, which is higher than in any year since the beginning of the period. The increase was mainly driven by industry, while emissions from the power sector decreased slightly for the fourth consecutive year.

Surplus of allowances

Over the last three years, the surplus of allowances in the European carbon market has been steadily declining, by an overall amount of almost half a billion allowances, mainly due to back loading, i.e. postponed auctioning of allowances. The reformed ETS will further address the surplus by reinforcing the Market Stability Reserve - the EU's mechanism established in 2015 to reduce the oversupply of allowances and to improve the EU ETS's resilience to future shocks. From 2019 (when the reserve will start operating) to 2023, the percentage of the surplus to be placed in the Market Stability Reserve will be doubled from the initially agreed 12%, to 24%. Moreover, as of 2023, reserve holdings exceeding the previous year's auction volume will no longer be valid. Together with the second publication of the Market Stability Reserve surplus indicator in May 2018, these reforms will lead to placing almost 265 million allowances (16% of the surplus) into the Market Stability Reserve from January to August 2019 instead of auctioning them. This will reduce the auction volume over the first 8 months of 2019 by some 40% compared to the corresponding volume in 2018.

Due to the doubled amount of allowances to be placed in the reserve for the first five years of its operation, it is widely expected that the surplus will continue to decline substantially in the coming years. Progress on these fronts has translated into increased confidence by market participants as illustrated by the reinforced carbon price signal over the last year.

Revenues from allowances

The total revenues generated by Member States from the auctions between 2012 and 30 June 2018 exceeded EUR 26 billion (in 2017 alone, the generated total revenues were EUR 5.6 billion). The EU ETS Directive provides that at least 50% of auction revenues, including all revenues generated from allowances distributed for the purposes of solidarity and growth, should be used by Member States for climate and energy related purposes. According to the information submitted to the Commission, Member States spent or planned to spend approximately 80% of these revenues for specified climate and energy related purposes in 2017.

Aviation

To provide continued momentum to the international process of establishing a global scheme to curb aviation emissions, and to facilitate its future implementation in the EU, the limited scope for aviation to only flights within the European Economic Area has been extended until 2023. As from 2021, a linear reduction factor will for the first time apply to the aviation sector, reducing the cap on aviation emissions by 2.2% annually.

EU ETS architecture

In the fifth year of phase 3, the EU ETS architecture has remained robust and the administrative organisation across Member States has proven to be effective. Moreover, the overall level of transparency, investor protection, and integrity in the carbon market has increased with the classification of emission allowances as financial instruments under the new financial market rules. An important step has also been taken towards the continued protection of the European carbon market against VAT fraud, with the adoption of an amendment to the VAT Directive to extend the application of the reverse charge mechanism derogation beyond the end of 2018.

Following the enhanced transparency and reporting requirements of the revised EU ETS Directive, the report provides for the first time an overview of the actual amounts of state aid spent by Member States on indirect carbon cost compensation in 2017.