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The EU Emissions Trading Scheme (ETS) and its reform in brief

The EU's emissions trading system (ETS) aims to reduce the industry's carbon emissions. Discover how it works and why a reform is needed.

MEPs adopted plans to reform the EU's emissions trading system on 6 February 2018. Read on to find out what it is all about.

What is the EU's emissions trading system all about?

Although the EU is the world's third largest CO2 emitter, it also pursues the most ambitious climate target: to cut emissions by at least 40% by 2030 compared to 1990 levels.

Launched in 2005, the emissions trading system (ETS) is one of the tools set by the European Union to reach this goal. It specifically targets the industry.

How does it work?

The emissions trading scheme obliges more than 11,000 power plants and factories to hold a permit for each tonne of CO2 they emit. This should provide a **financial incentive to pollute less**: the less you pollute, the less you pay. Companies have to buy them through auctions and the price is affected by demand and supply.

However, some of the permits are allocated for free, particularly in sectors at risk of having companies move production to other parts of the world with laxer emission constraints.

Why is a reform needed?

At the moment these permits are very cheap, because demand for them dropped due to the economic crisis, while the supply has remained constant.

The emissions trading system has been characterised by a large imbalance between the supply and demand of allowances, resulting in a surplus of about 2.1 billion in 2013. The surplus was reduced slightly in 2014 and then fell significantly to 1.78 billion allowances in 2015 and to 1.69 billion allowances in 2016.

Having a large surplus and low prices discourages companies from investing in green technology, thereby hampering the scheme's efficiency in combatting climate change.

What is the ETS reform about?

The current ETS directive runs until 2020. Its reform aims to design the future of the EU carbon market for the post-2020 period, with plans to boost greenhouse-gas emission curbs in the framework of the Paris Agreement. To boost prices, the proposal includes an increase in the annual reduction of emission allowances to be auctioned.

To reduce oversupply, MEPs want to double the Market Stability Reserve’s (MSR) capacity to mop up excess emission allowances on the market. MSR aims to better align supply and demand of allowances by placing surplus allowances in a reserve, from which they can be released in case of a shortage. When triggered, MSR would absorb up to 24% of excess credits in each auctioning year.

The proposal introduces also two **new funds to help foster innovation** and tackle the transition to a low carbon economy:

1. the Innovation Fund will provide financial support for renewable energy, carbon capture and storage and low-carbon innovation projects
2. the Modernisation Fund will help to upgrade energy systems in lower-income EU countries

EU efforts to cut greenhouse gas emissions

There are other measures to help the EU implement its commitments under the Paris Agreement on climate change, cutting emissions in the EU by at least 40% by 2030 compared to 1990 levels in all economic sectors:

- the Effort Sharing Regulation on national targets to cut greenhouse gas emissions from transport, building, waste, agriculture)
- the Land Use, Land-Use Change and Forestry Regulation
- Stricter CO2 emissions standards for cars

This is an update of the article originally published on 13 February 2017.

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