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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 it was reformed.

The updated Emissions Trading System explained
https://multimedia.europarl.europa.eu/en/video/v_N01_AFPS_230517_FIT2

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 substantially by 2030 and bring them down to net zero emissions by 2050.

Launched in 2005, the emissions trading system (ETS), part of the Fit for 55 package, is one of the tools set by the EU to reach this goal. It specifically targets industry.

How does it work?

The emissions trading scheme, based on the polluter pays principle, obliges more than 10,000 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 have been allocated for free, particularly in sectors at risk of having companies move production to other parts of the world with laxer emission constraints.

Regulating the price of carbon

After the 2008 financial crisis, these permits were very cheap, because demand for them dropped, while the supply remained constant.

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

To overcome this problem, the EU created the Market Stability Reserve in 2015 to better align the supply and demand of allowances by placing 24% of all ETS allowances in a reserve, from which they can be released in case of a shortage. In March 2023, the Market Stability Reserve was extended to 2030 to protect the EU against falling CO2 prices due to external shocks such as Covid-19. Lower CO2 prices would mean there is less of an incentive for industry to cut greenhouse gases.

ETS reform under EU Green Deal

To align the emissions trading system with the higher emission reduction targets of the European Green Deal, the EU agreed in December 2022 on an update of the scheme, cutting industry emissions 62% by 2030.

What are the reforms?

Compared to the original proposal by the Commission, MEPs wanted more ambitious goals. The changes following the deal between Parliament and EU governments include:

- Further decreasing the number of annual allowances available until 2030 to cut emissions 62% by 2030, one percentage point more than the Commission proposal (61%).
- Increased financing for innovative technologies and to modernise the energy system via an Innovation Fund and a Modernisation Fund. A share of revenues from the new trading system will be allocated to the Social Climate Fund, which aims to support households and businesses affected by energy poverty.
- The phasing out of free allowances to industry by 2034, while the EU's Carbon Border Adjustment Mechanism will simultaneously be phased in and fully operational by 2034. The mechanism would apply a carbon price to imported goods from less

ambitious countries and prevent companies moving production to a country with less stringent greenhouse gas emission rules.
- Extension of the scheme to include maritime transport
- The inclusion of emissions from municipal waste incineration installations from 2024.
- The creation of a separate emissions trading system (ETS II) for buildings and road transport as of 2027. ETS II could be postponed until 2028 to protect citizens, if energy prices are exceptionally high and a new price stability mechanism will be set up to ensure that if the price of an allowance in ETS II rises above €45, 20 million additional allowances will be released
- The revision of the Emissions Trading System for aviation aims to phase out free allowances to the aviation sector by 2026 and to promote the use of sustainable aviation fuels.

All revenues from the Emissions Trading System will be used exclusively for climate-related activities.

Discover how the EU wants to cut emissions from planes and ships

Background

MEPs and EU governments reached a deal on a more ambitious Emissions Trading System in December 2022. In April 2023, Parliament approved the revised version and the Council endorsed it. The directive came into force in May 2023.

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 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
- How the EU reduces greenhouse gases beyond CO2

Check out our infographics on the EU's progress towards reaching its 2020 climate change targets.

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

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