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Harder, Better, Faster, Stronger

Two key elements to get right in the EU carbon market review

The upcoming revision of the EU carbon market rules is an opportunity to ensure that industries covered by it cut their pollution in line with the EU Green Deal objectives and the Paris Climate Agreement. Agreeing on a faster pace at which emissions decrease annually and a stronger mechanism to deal with the surplus will be at the core of the legislative work ahead.

Virtual toasts have most likely been had among carbon market geeks over the past few weeks. Whereas less than a year ago, the pandemic-induced lockdowns sent the EU carbon price crashing, the start of 2021 has seen it reach a record of just over 40 euros. So far this year, the price has risen by over 20%.

There are many reasons for the price hike. Importantly, it follows from the EU leaders' agreement on a ramped-up short-term climate target which means a revision of the scheme that will have to lead to steeper emission cuts. Cold temperatures across Europe and higher natural gas prices have also driven up the demand for pollution permits which contributed to the price increase. Auctions began weeks later than normal in January which has meant a period without additional supply in the market. There is also no denying that the so-called market stability reserve which absorbs excess allowances off the market since 2019 is doing its job.

It seems that Europe is finally putting a proper price on pollution. To make sure that this continues to be the case, decision-makers must agree on strong measures as the carbon rules are revised from this summer.

This article focuses on two essential elements of the revision: the pace at which pollution goes down and the mentioned tool that withdraws permits off the market as needed in order to ensure a strong price signal. In addition to these measures, it will also be important to ensure no more free emission allowances are handed out to large polluters, a topic we discuss in more detail here.

We need to pick up the pace

To do its fair share of global climate action, the EU needs to cut emissions by at least -65% by 2030, and be climate-neutral by 2040. Covering about 40% of the EU's greenhouse gas emissions, the carbon market plays a key role in achieving these goals.

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The rate at which emissions decrease annually (the "linear reduction factor", LRF) is of key importance here. Currently, the LRF is set at 2.2%. However, this reduction would lead to the full decarbonisation of the EU's power and industry sectors only in 2058. For the cap to reach zero by 2040, the pace at which emission allowances decline should drastically pick up.

Overall, the emissions cap has been much higher than the actual emissions ever since the last economic crisis. In 2019, the European Commission estimated this gap to be around 250 million allowances. This difference is expected to continue and could also grow as a consequence of the pandemic-induced economic slowdown.

If the cap is not aligned with the actual overall emissions, we can expect another massive surplus on the market. This will of course bring the prices down. To ensure that the cap better reflects real emission levels, it should be readjusted through a one-off reduction of 450 million allowances as soon as possible.

With such a one-off removal of allowances, the above-mentioned LRF should increase to 3.1% as of 2023. If the number of allowances is left as it is, then a much steeper annual reduction pace will be necessary - 4.3%.

It is therefore important to combine both of these measures in order to have the desired impact. Leaving these changes until later will inevitably require a much greater effort in a shorter amount of time.

Let the market stability reserve do its job

The market stability reserve was set up in response to the massive surplus on the market and started to take out extra allowances in 2019. If the total number of allowances in circulation in any given year is greater than 833 million, 24% of them go into the reserve. From 2024 onwards, however, this share is set to decrease to 12%.

If, on the contrary, there are fewer than 400 million allowances in circulation, the reserve releases 100 million permits on the market (needless to say that this has not happened). Finally, if there are more allowances in the reserve than what has been auctioned in the previous year, the system invalidates a number of allowances corresponding to the difference.

The market stability reserve has proven effective in supporting the carbon price in recent years. However, it was designed to only handle the oversupply accumulated in the past. It is not fit to deal with current or future surplus (linked to e.g. the Covid-19, economic downturn, planned coal plant closures...).

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For example, as European governments implement their coal phase-out plans, we can expect a 2.07 billion tCO2e worth of carbon pollution reductions between 2021 and 2030. This logically means that there will be less demand for pollution permits and lead to a significant amount of allowances adding to the current surplus and pressing down the carbon prices.

In light of this, the reserve should be equipped to absorb more - not fewer - excess permits off the market. The intake rate needs to increase to 36% from 2024 onwards. Furthermore, the threshold for activating the withdrawal of permits should decline over the years and allowances that have been in the reserve for more than three years, should be automatically cancelled.

It is encouraging to see the carbon market rules revised again after the last round in 2015-2017. Lawmakers mustn’t waste this opportunity. They need to make sure that the carbon price gives us reasons to toast it in the future as well.