The Washington Post
Democracy Dies in Darkness

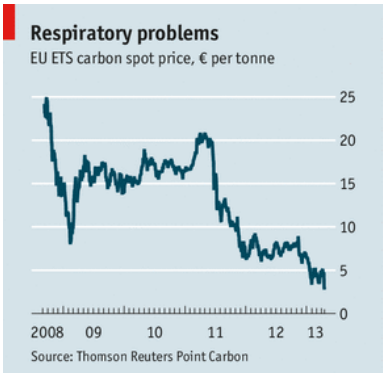
Europe's cap-and-trade program is in trouble. Can it be fixed?

By Brad Plumer
April 20, 2013

The European Union has long prided itself on taking the lead in tackling climate change. But, this week, the continent's flagship program — a cap-and-trade program for carbon-dioxide emissions — came in for criticism after a reform effort failed and the carbon market crashed. So what's the problem? And can it be fixed?

Let's start with some background. The E.U.'s Emissions Trading Scheme works by setting an overall cap on carbon emissions for about half of Europe's industries. Companies get a certain number of pollution permits that they can trade among themselves. As the cap ratchets down each year, the number of permits is supposed to dwindle and the "price" on pollution keeps rising.

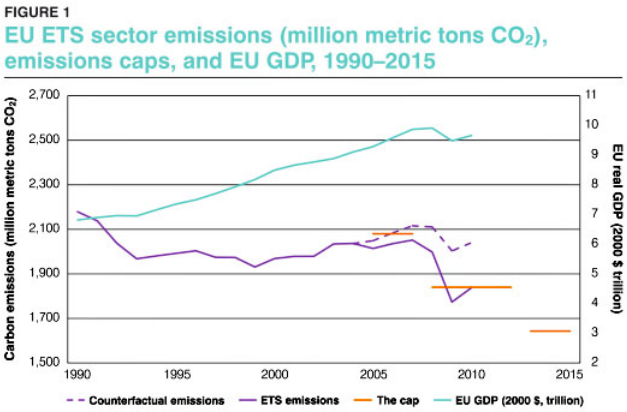
Over the last few years in Europe, however, there has been a glut of permits. Policymakers initially gave too many away, and then there was a huge recession. So Europe's emissions are well under the cap and permit prices had been hovering below $9 per ton since 2011. Companies have little incentive to make any drastic changes. Polluting is cheap:



The European Commission wanted to change this by delaying a scheduled release of new permits.* This policy, known as "backloading," would have been the first of several possible reforms to the ETS. But backloading failed by a vote in the European Parliament of 334 to 315 this week. Immediately after, the price of carbon plunged to around $3.40 per ton and analysts were calling the trading scheme "completely toothless." The prospect for further reforms is uncertain.

So what can we learn from all this? Basically, the E.U.'s climate policy seems to be somewhat confused. There are a couple big things going on here:

1) From one angle, the cap-and-trade program is working — emissions are down. Since the ETS came into existence, Europe has been meeting its emissions goals. Yes, that's partly because the continent has been grinding along in an economic depression, but emissions are still lower than one would otherwise expect:



Source: Environmental Defense Fund

This is, essentially, how cap-and-trade is supposed to work. When meeting the targets is easy (and it's much easier when the economy is in the toilet), then the price of carbon goes down. If the euro zone ever recovered from its pit of endless despair, then the price of polluting would presumably rise again.

This is a point Poland keeps making, as FT Alphaville's Kate Mackenzie points out — and this was the Polish delegation's reason for opposing tweaks to the system: "Growth will return and the price will find its equilibrium again. No administrative meddling is needed or else we might create the impression that such measures are standard practice."

Now, Poland's position is arguably too sanguine. Europe's cap-and-trade program has a number of other flaws that may need fixing, like the fact that policymakers gave away too many permits initially. (In other words, there may be too many permits out there *even after* accounting for the recession.) Still, there's an argument that low prices aren't inherently a problem.

2) Yet many people in Europe *want* a high price on carbon. Many politicians and analysts weren't satisfied with simply staying under the cap. They wanted a high price on carbon that would drive big changes to the continent's energy supply. And, it's true, the ETS wasn't providing that. As a recent report (PDF) from the International Energy Agency points out, Europe would need prices to rise to $65 per ton before power plants would switch from coal to natural gas. Instead, prices have been at $7 per ton.

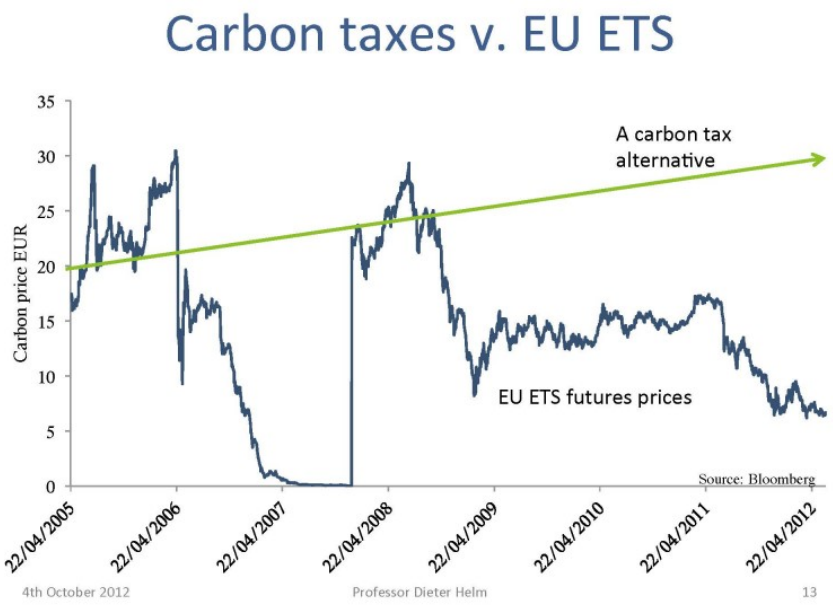
David Hone of Shell had been making a similar argument. In his view, carbon capture and sequestration (CCS) for coal plants is an essential technology for tackling climate change. And since CCS is a difficult technology to develop, utilities need to start working on it now, or they'll never be able to deploy it in time to cut emissions sharply by 2050. Yet the price on carbon isn't nearly high enough to spur CCS development.

Even for people who aren't fans of natural gas or CCS, the same argument holds. Companies aren't going to develop complicated clean-energy technologies of the future without a much higher price on carbon.

3) What's more, Europe is undermining its cap-and-trade system with "complementary" policies. German economist Hans-Werner Sinn has made this point often. In addition to cap-and-trade, Europe *also* has a renewable energy mandate and an energy-efficiency mandate. Since utilities and companies already are already required to meet those, they have a much easier time meeting their pollution targets. So, naturally, that puts downward pressure on carbon prices in the trading scheme.

4) So it's worth asking, should Europe just get a carbon tax instead? When you add these all up, it's hard to escape the idea that many people in Europe seem to want a carbon tax. A carbon tax that rises slowly over time would keep the price of emitting greenhouse-gases stable — and the price would remain high even if European policymakers wanted to tack on renewable mandates and other policies.

Oxford's Hans Dieter has used this graph to make the point:



Yes, a carbon tax is less flexible to changes in circumstance — it would keep energy prices high even during a recession. But many policymakers seem to find that flexibility in cap-and-trade a problem.

Trouble is, there's no reason whatsoever to think a carbon tax would be politically easy. For one, any major change to the E.U.'s climate policy would take many years to negotiate and approve. All 27 countries would need to take a vote. And countries like Poland, for one, seem quite happy with the current low pollution prices.

That means Europe is likely stuck with trying to reform its cap-and-trade program. According to Point Carbon, further big changes aren't likely to happen until 2016 at the earliest.

In any case, Europe's experience will certainly provide a lesson to other countries. Australia is currently preparing its own cap-and-trade system (assuming that the Liberals don't come to power and scrap it), and a cap in California just went into effect. So there are a lot of lessons here in how to design — or how *not* to design — a climate policy.

**Correction:* The European Commission proposed the change to the cap-and-trade system and the European Parliament voted it down.

https://www.washingtonpost.com/news/wonk/wp/2013/04/20/europes-cap-and-trade-program-is-in-trouble-can-it-be-fixed/?utm_term=.536ede6581b6