The European carbon market isn't working — and social liberals should be worried

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SLF Long Reads series
Number 5
February 2017

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Published and promoted by Edward Robinson on behalf of the Social Liberal Forum, both at Social Liberal Forum, MRG Building, 54 Commercial Street, London, E1 6LT.

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Introduction

Climate change remains one of the greatest threats to liberalism in our midst. Global greenhouse gas emissions (GHG) continue to rise, albeit at a slowing rate, and their atmospheric concentration marches towards what the global scientific community considers a safe limit for human civilization. Alongside Trump and Brexit, 2016 may go down in history as the year atmospheric concentrations of CO_2 breached 400 parts per million (ppm) for the first time in at least 800,000 years. The absolute limit to have even a 50 per cent chance of keeping global average temperature rises below 2 degrees is 450 ppm although many scientists recommend 350 ppm.

So the task for the international community gets more difficult every year that emissions do not fall. For advanced economies like the UK, in order to have any chance of honouring our emissions-cutting commitments (currently enshrined in UK law, EU law and international convention through the Paris Agreement) we need to reduce our annual emissions to around 2 tonnes of CO_{2e} per person by 2050. We are sitting at around 7 tonnes per person at the moment. Getting to 2 tonnes would leave us with around the same average emissions per person that a country like Bolivia or North Korea has today.[1] A single transatlantic flight on today's technology would wipe out at least 50 per cent of a 2 tonne carbon budget on conservative estimates, or 100 per cent on less conservative ones.

What if we fail? The negative effects on civilisation of average global temperature rises of over 2 degrees have been well documented by the IPCC, the World Bank[2] and (more dramatically) in a recent documentary-film, *The Age of Consequences.*[3] All of the research points to the fact that many eco-systems – which have never been forced to adapt so quickly to climatic change – could collapse.

But as great a threat to liberalism as the effects of climate change (the disease), could be the medicine recommended by those who see liberalism and capitalism as climate change's principal stimulants and have always been hostile to liberalism. A range of "Deep Green" to anti-capitalist political voices, combined with intellectuals like Naomi Klein and Slavoj Zizek have long been arguing that capitalism and liberalism are not up to the task of solving global collective problems. Many of these voices seem to envisage a kind of global *war economy* to tackle climate change, with all the restrictions on personal freedom that would entail, or a return to a kind of pre-industrial life. On the other end of the spectrum are those who simply deny climate change is happening or refuse to recognise its severity.

So social liberals have a big responsibility. Social liberalism was born in attempts to reconcile individual freedom with collective flourishing and it has a good track record of enacting pragmatic and popular legislation to tackle pollution. Perhaps uniquely, social liberalism openly acknowledges the two

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[1] 'List of countries by carbon dioxide emissions per capita', *Wikipedia*, last updated 25 January 2017.

[2] 'Turn Down the Heat: Confronting the New Climate Normal — World Bank Beta Report No. 3', *The World Bank beta*, November 2014.

[3] *The Age of Consequences - Theatrical Trailer* (PF Pictures, 2016).

faces of the market: its propensity to create negative externalities and inequality for sure, but also its remarkable ability to encourage innovation and efficiency.

It is this qualified faith in the market combined with respect for individual rights that should render social liberals favourable to emissions trading. And this is why we should be concerned about the plight of the EU *Emissions Trading System* (EU ETS).

The EU Emissions Trading System

The EU ETS was launched in 2005 as the world's first continent-wide *cap and trade* scheme. Today is covers 31 countries: the 28 EU member states as well as Iceland, Lichtenstein and Norway. It covers sectors representing around half of the EU's total emissions (the power sector and most industrial sectors). A decade-long debate still rages as to whether it would have been better to institute an EU-wide tax on carbon emissions rather than attempt to find a carbon price through the creation of a market. But at the time it was thought carbon trading would be more innovation-friendly, as well as bureaucratically simple, than imposing a tax.

The ETS sets an overall cap on EU-wide GHG emissions, in line with (in theory) the EU's targets to cut these emissions (a 20 per cent cut on 1990 levels by 2020, a 40 per cent cut by 2030). These targets are now part of the Paris Agreement.

Companies in sectors covered by the ETS have to "buy and surrender" enough emissions allowances on a spot market to match their annual emissions. Emissions trading is supposed to incentivise the most cost-effective ways to cut emissions. If you can easily cut your emissions, you invest in the tech, but if it's cheaper to buy allowances from the market, you buy them. Crucially, though, this only works if the price of emissions allowances (much like parking tickets) is high enough to be worth avoiding. A big challenge, therefore, is to ensure that the number of total allowances reduces at the right speed to keep up with the deployment of low carbon technology across Europe and to track the business cycle. But this hasn't been happening.

One of the main reasons the ETS isn't working well in the power sector is that the cap was set too low. Policymakers did not anticipate the speed with which renewable generation would come onto grids over a decade. Renewables (including biomass and hydro-electric as well as wind and solar) now contribute nearly 30 per cent of Europe's electricity generation. And – in a sign that market-driven innovation really does work – their costs have fallen precipitously. Solar generation costs are falling at around 10-15 per cent annually. A big moment for the wind sector, meanwhile, came last year when the Swedish state-owned energy company, Vattenfall, bid to offer offshore wind energy at under €50 per MWh, which is basically on par with gas.[4] One of the problems, though, is that renewable sources are always competing with fossil fuel infrastructure that is already built and so can afford to cut their losses by generating cheaply. Electricity grids are not level playing fields.

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[4] 'Vattenfall wins tender to build the largest wind farm in the Nordics', *Vattenfall*, 9 November 2016.

But the ETS also covers industrial installations (like factories). So a second challenge has been what to do about the carbon emissions that are "embedded" in imports to Europe and/or preventing industries from fleeing overseas to less regulated jurisdictions. In order to mollify high-emitting sectors, it was decided to draw up a list of industries "at risk of carbon leakage". If your sector is on this list (and the entire steel, cement, chemicals and many others are) you still get all your emissions allowances for free, based on a "benchmark" linked to your sector's previous emissions. The benchmark is supposed to ensure that it's the more efficient plants that set the standard. Unsurprisingly, though, the question of which sectors are included on this "at risk" list, and what their benchmarks are, has been the subject of a lot of lobbying which has led to a lot of sectors being included on the list and generous benchmarks.

When you combine the policy circumspection around carbon-leakage with a cap that has not fallen fast enough to accommodate the deployment of renewables onto the system, as well an economic slowdown after 2008, the result has been a huge oversupply of emissions allowances and – therefore – a very low carbon price.

The core problem with a low carbon price is that it does nothing to incentivise low carbon investment beyond *business-as-usual* and often locks in incumbent technology, actively dissuading companies from investing in new technology and techniques which require an upfront investment and confidence that investment today will lead to future competitiveness.

At the moment the EU carbon price is little above €5 where really it ought to be around €30 or more.[5] This means that even coal power can compete on price. So it is only the fast falling costs per MWh and other environmental policies like *emissions performance standards* and national targets (and subsidies) for renewable electricity, that are driving the uptake of clean technologies.

Stalling reforms

So the ETS is in a mess and is in the process of reform coordinated, oddly enough, by a British Conservative MEP in the European Parliament, Ian Duncan.

There are a number of policy options available to raise the carbon price out of the doldrums. The first is to speed up the overall reduction of the EU-wide emissions cap so that fewer allowances are issued in each phase. Connected to this are proposals to change the "base year" from which cuts are demanded to bring it into line with current emissions. A third is to retire allowances forcibly and/or place them into a reserve "fund – which MEPs partially rejected in 2013 after intense lobbying from certain industries. And a fourth is to reduce the number of free allowances being issued every year to high-emissions industries and to try different ways to combat carbon leakage.

The big problem is that the reforms that have been proposed by the European Commission and the amendments so far due for voting on in the

[5] Phil MacDonald, 'EU Carbon Price Falls Below €4', *Sandbag: Smarter Climate Policy*, 4 September 2016.

European Parliament on 15 February do not go anywhere far enough to stimulate carbon price inflation.

There is an interesting new proposal included in the environment committee's report to take the cement sector (5 per cent of EU emissions) off the carbon leakage list and apply a WTO-compliant "border adjustment" to cement imports, but this will struggle to pass the whole parliament or could be killed by national governments even if it does. Environmentalists are keeping their eyes peeled but – as expected – the lobbying against reform is intense. Social liberals should support the proposals as a step in the right direction. But they should also push for much more rapid falls in the rate at which the overall cap falls across all ETS-sectors and the effective cancellation of more of the surplus allowances that have been banked up in the past (which some analysts put at around 1.7 billion tonnes of GHG).

Why care about a failing emissions trading system?

If much stronger reforms to the ETS are not agreed by the European Council later in 2017 (in March of June probably) then the ETS may never function as proper carbon market and this would undermine Europe's standing on the world stage and as a destination for low carbon investment.

There are many people who argue that the ETS is now irrelevant, all that matters is that it sets a cap on overall emissions per sector and raises some public revenue, which can be spent on R&D or energy efficiency.

It is certainly true that the heavy lifting in terms of clean tech deployment (especially in the power sector) in recent years has not come from the ETS but from national renewables targets combined with state subsidies, falling costs and other regulatory tools like *emissions performance standards*. I would not advocate removing these policies. But they are more fragile than we sometimes imagine and they are inherently nationally determined – despite EU attempts to create a genuine Energy Union which are progressing slowly but always running into perceived conflicts of national interest.

Likewise, anyone watching the speed with which the UK Green Investment Bank is being privatised, the problems caused by the stark U-turns on solar subsidies or the threats to ban onshore wind, which the Conservatives have been issuing for years, should worry about the degree of control national governments have over the process of de-carbonisation at this crucial time. **On the other hand, they should note the huge impact carbon floor price has had (just last year) in pushing coal off the system in favour of gas and renewables** — with a huge commensurate cut in UK emissions. The Lib Dems pushed hard for a *carbon floor price* to be included in the Coalition Agreement and Britain continues to reap the rewards nearly seven years after that agreement was inked.

What the *carbon floor price* (which is now effectively GBP 30 per tonne) has done is create a genuine price signal and this is precisely what a functioning EU-wide carbon price could do, independent of the whims of national governments. A robust ETS would be "populist proof" and so it is worth continuing to push for. Cutting the number of free allowances to industry has long been a Lib Dem policy and we – as social liberals – should make it our own. We should also push for the UK to remain both in the EU Energy Union (which may be a matter of national security) and the EU ETS.

The aim of policymakers all over the world should be to create a series of self-sustaining regional carbon markets that finally shift investor and consumer phycology towards taking environmental externalities into account on bottom lines, thereby incentivising the development and deployment of clean tech in a huge range of sectors. There are vast amounts of additional investment needed for Europe and the world to make "the switch" to a low-carbon society. Social liberals should remain firmly at the forefront of this social and economic transformation.

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