

MAKING EUROPEAN ETS MARKET GLOBAL: A PROPOSAL FOR REFORM

Luca d'Agnese



Europe's current cap-and-trade system for CO₂ emissions, known as the Emissions Trading System (ETS), has attracted widespread criticism from representatives of European industry and political parties. Critics argue that it makes energy substantially more expensive and threatens the survival of European industry. The changes introduced by the Clean Industrial Deal have not quelled this opposition.

These criticisms are rooted in several well-established challenges:

- In several European countries, including Italy and Germany, fossil fuel generators act as the marginal producers that set electricity prices for much of the year. ETS costs therefore increase electricity prices by approximately €30-50/MWh.
- Gas and coal used in industrial processes have no easy substitutes. Carbon capture and storage remains an emerging technology, hydrogen is extremely costly, and electrification is not always practical. Making these alternatives economically viable, where they are technically feasible, will likely require further increases in CO₂ prices.
- This situation is unlikely to change in the short to medium term, as economic incentives to build renewable energy capacity are insufficient to overcome permitting delays and network constraints.
- Extending the ETS to other sectors, such as waste treatment, and continuing to reduce the supply of allowances are likely to intensify these pressures.
- The US withdrawal from the Paris Agreement, alongside Europe's success in cutting emissions and its consequently smaller share of global CO₂ emissions, is giving greater weight to the objection: "Why should Europe sacrifice its industrial competitiveness to be the only climatically virtuous region in the world?"

However, the seemingly simple solution of scrapping mandatory targets and the ETS as their enforcement mechanism is unlikely to benefit Europe in the long term. Beyond the irony of abandoning climate objectives when record-hot summers are disproportionately affecting Europe, as they have this year, such a reversal would create several risks to European competitiveness:

- Europe's energy autonomy and security require additional renewable energy capacity. Removing EU targets and the incentives created by the ETS would threaten the pace of its development.
- Investment in new technologies would suffer from such a "stop-and-go" approach to regulation.
- European manufacturers could fall further behind in the transition towards electrification led by China, as has already happened in the automotive sector.

An alternative is to substantially develop and expand the initial proposal to accept 5% of "high-quality, high-integrity international CO₂ certificates", already included in the July 2026 proposal for a directive reforming the ETS.

As currently proposed, this measure is likely to have only a limited effect on ETS prices, potentially becoming significant only in the final years, when the 5% would represent a larger share of the remaining allowances. Its impact would also be delayed, as it would begin in 2030. Moreover, it would not deliver additional reductions in global CO₂ emissions, since reductions elsewhere would replace those within Europe.

The Commission's proposed limit on the volume of eligible international certificates is understandable. Alongside the difficulty of identifying genuinely high-quality, high-integrity certificates and avoiding a repeat of the influx of worthless certificates that contributed to the collapse in carbon prices in the early 2000s there is a risk of significant price effects in both Europe and the countries supplying them.

Where the originating country has a large market and much lower carbon prices, as in China, unrestricted exchange could flood Europe with cheap certificates. With CO₂ trading at €10-15 per tonne in China, compared with €70-90 in Europe, this could drive European prices down and substantially weaken existing incentives to decarbonise. Conversely, where the originating market is comparable to Europe's in size, or smaller, demand from Europe could push its prices towards European levels, increasing costs for consumers in that market.

The proposed alternative is to allow certificates to be exchanged at a negotiated ratio, rather than on a one-to-one basis. For example, a six-to-one ratio with China would mean that certificates representing six tonnes of CO₂ in China would be equivalent to an allowance for one tonne in Europe.

This would offer two significant benefits:

- **More manageable price effects.** The exchange ratio could be set using the previous year's prices, helping to limit sharp price movements in either market.
- **Greater reductions in global emissions.** Each tonne of European emissions covered by international certificates would require reductions equivalent to several tonnes elsewhere. For example, the 260 million tonnes of European allowances envisaged for replacement by international certificates under the current proposal could deliver a net additional global reduction of more than one billion tonnes if exchanged with China at the ratio implied by current relative prices.

Implementing this proposal would require a designated European entity with the authority to negotiate both the volume of certificates exchanged and the conversion ratios. The European Commission would be a natural candidate. However, its political character could undermine its credibility in this role. Member States would be reluctant to cede authority, while commissioners themselves are politicians with views on the inevitable trade-offs these negotiations would involve.

There is therefore a case for establishing a new, purely technical body responsible for verifying the quality and integrity of CO₂ certificates and negotiating exchange volumes and conversion ratios.

This entity would perform a role in carbon markets analogous to that of the European Central Bank in financial markets: preserving price stability.