A protracted recession and fragmented carbon market policies in the European Union and its member states threaten to undermine the perception of the EU Emissions trading Scheme (EU ETS) as a blueprint for the future of emission trading schemes in the rest of the world. A key challenge for the ETS has been an oversupply of emission allowances resulting from optimistic assumptions concerning the economy. An oversupply of allowances creates market uncertainty and undermines incentives for investment in renewable energy and energy efficiency.

It would be wrong to conclude that the EU ETS is failing, the International Emissions Trading Association (IETA) says in a new position statement , and the proper response to economic volatility should not be a series of ad hoc market interventions. In order to provide an investment climate that provides sufficient confidence to support robust investment in green technology and renewable energy (the very investment needed to establish a trajectory for long-term economic growth), the European policy makers must show that they have a responsive but unwavering game plan.

At the heart of concerns over an inconsistent regulatory approach is a recent vote by an EU parliamentary committee for measures that would establish a set-aside for carbon allowances (removing a number of allowances from the ETS), reducing the oversupply of carbon allowances that has resulted from a weak EU economy.

The set-aside proposal is contained in a proposed amendment of the EU's Energy Efficiency Directive, which calls on the European Commission (EC) to report on the likely impact of incentives for investment in low-carbon technologies and on the risk of carbon leakage. [1] The proposal further authorizes the European Commission to "implement appropriate measures, which may include withholding of the necessary amount of allowances."

EU member states are divided on the issue of setting aside allowances to reduce the supply, because of the impact of potentially higher compliance costs for industries struggling in a poor economy. Proponents of a set-aside agree that a tighter supply of allowances would drive up carbon prices, but believe such a move would make investment in renewable energy sufficiently attractive to put the EU on course to meet its mid and long-term climate objectives under Renewable Energy Directive
. Yet short-term, ad hoc measures to support higher carbon prices will not deliver the predictability that investors will require for substantial long-term investments in renewable energy. Absent a convincing commitment to a sustained regulatory approach, investment in

energy based on fossil fuels will continue to be seen as providing more reliable returns in the energy sector.

The IETA statement calls for a policy approach that reaffirms a consistent course in carbon policy while developing procedures that address the foreseeable need to periodically change assumptions regarding the business-as-usual baseline for energy sector carbon emissions. According to IETA, the introduction of new mechanism for recalibrating baseline assumptions would be better than a direct intervention in the form of a set-aside. It must be widely understood as a one-time event that fixes a shortcoming in the original framework for establishing EU-wide emissions caps and reinforces a system that can withstand significant volatility in the economy.

While European policymakers must take exceptional care to avoid further undermining confidence in the EU ETS, taking no action at all carries its own risks. Since allowances may be banked (excess allowances may be applied in future compliance periods), there is significant concern that excess allowances will continue to accumulate, creating additional uncertainty.

IETA does not dispute the need for policy makers to implement measures to strengthen the EU ETS system, but stresses that such a mechanism must be broadly understood and predictable, and based on widely-known market indicators. To avoid undermining the confidence of market participants, the process of developing this mechanism must be careful, transparent, and involve thorough stakeholder consultation, preferably by an independent ETS Review Board.

The EU ETS is not the only emissions trading system in which an oversupply of allowances has limited the incentives for investment in renewable energy. Northeastern US states that are members of the Regional Greenhouse Gas Initiative (RGGI) sharply reduced the number of available allowances in January of 2012 as part of an effort to boost that program's impact. Connecticut, Delaware, Massachusetts, New York, Rhode Island and Vermont plan to permanently retire 72 percent of (67 million) unsold carbon allowances in the RGGI's cap-and-trade system. [2] Maryland has recently indicated that it intends to eliminate a portion of its unsold allowances as well. Supporters of the RGGI program have overwhelmingly supported the elimination of excess allowances and do not see the move as creating uncertainty.

Conclusion

If implemented properly, the a more responsive mechanism for aligning emission caps with actual economic performance data would not represent a policy shift or qualify as a market intervention in the conventional sense of the word. Instead, such a move would be a critical refinement that enhances predictability and long-term confidence . However European regulators will have to keep a close watch on the potential for carbon leakage and ensure that any new mechanism does not expose carbon leakage-prone industries to higher costs. Unlike conditions in the northeast US energy market, the EU ETS encompasses a broader range of industries and opportunities for the offshoring of carbon-intensive activities. At stake is confidence in the very foundation for investment in a green economy.

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[1] European Parliament Committee on Industry, Research and Energy, Compromise Amendments 1 - 18 on the proposal for a directive of the European Parliament and of the Council on energy efficiency, 2011/0172(COD)22.02.2012, Available at http://www.europarl.europa.eu/meetdocs/2009_2014/documents/itre/dv/eed_compam_/eed_compam_en.pdf
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[2] New York Times, *Regional Cap-and-Trade Effort Seeks Greater Impact by Cutting Carbon Allowances*, Mireya Navarro, January 26, 2012. Available at http://www.nytimes.com/2012/01/27/nyregion/in-greenhouse-gas-initiative-many-unsold-allowances.html?_r=3 .