

## Public consultation

### “Options for structural measures to tackle the supply-demand imbalance of the EU ETS in phase III (2013-2020) and beyond”

(Petra Sieber, Constanze Adolf / 4 February 2013)

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**Information on the consultation:** [http://ec.europa.eu/clima/consultations/0017/index\\_en.htm](http://ec.europa.eu/clima/consultations/0017/index_en.htm)

**Consultation document: The state of the European carbon market in 2012**

[http://ec.europa.eu/clima/policies/ets/reform/docs/com\\_2012\\_652\\_en.pdf](http://ec.europa.eu/clima/policies/ets/reform/docs/com_2012_652_en.pdf)

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## Background:

Stakeholders and experts in the field of the European carbon market are invited to comment on the structural options and views reflected in the report "The state of the European carbon market in 2012", which serves as the consultation document.

## Green Budget Europe's answer:

The arguments below are based on the assumption that the Commission's back-loading proposal of pulling 900 million allowances out of the market between 2013-2015 and re-injecting this volume in 2019 and 2020 will be adopted as a short-term measure. The resulting modification of the auctioning timetable is an important temporary solution allowing for a more stable phase III.

However, back-loading emission allowances does not affect the structural surplus of up to two billion European Union Allowances (EUA) between 2013 and 2020. This becomes very obvious when one assumes rational economic behaviour which appears to be reasonable in a market economy. Then the market participants would clearly understand that, anticipate the impacts of such a back-loading and thus discount the value of the seemingly "additional" future allowances in 2019/2020 to their value nowadays. This would in fact be the same as the value today if no back-loading would be considered, apart from some possible minor interest and liquidity differences. Hence, even the back-loading would not achieve much, if anything at all. Hence, Green Budget Europe is sceptic that the back-loading will have any meaningful impact and doubts whether it is worth the political effort.

In order to address the long-term effects of the current imbalance between growing supply and stagnating demand, amendments of the EU ETS Directive have to be considered. Compared to back-loading, which can be implemented by an amendment of the Auctioning Regulation, structural measures change the design of the EU ETS more profoundly. For this reason, different options to improve the functioning of the carbon market and their implications for other policies have to be taken into account.

The surplus of emission allowances generally raises two problems related to the low carbon price signal:

- 1) Due to a lack of incentives to invest in low-carbon technology today, it undermines the achievement of the EU 2050 long term target at the lowest cost.
- 2) It substantially reduces potential revenues from auctioning and thereby cuts the funding budget for green technology, climate policy and sustainable development in Europe's economy as already planned in by many governments.

Additionally, the oversupply of at least 2 billion EAUs does not allow for a stable price signal and thus is running contrary to the aim of creating sustainable and reliable framework conditions for future investments. Potentially higher but stable prices are not to be considered as economically detrimental, but as providing the necessary long-term framework conditions. But in order to enhance competitiveness of low-carbon technologies and economic prosperity, it is essential to stabilise the market situation for long-term investment. If the EU ETS shall contribute to more sustainable production and consumption patterns in the long run, it is crucial to tackle the current surplus by implementing the most effective measure(s) of the following options.

## Ranking of options

GBE recommends ranking these options as follows and thus making political efforts accordingly. However, GBE stresses, that it is not about mutually exclusive options, but that it is often necessary to pursue several options at the same time. This is necessary on the one hand for political reasons as there remains uncertainty as to which option will eventually be politically accepted and

implemented and how; on the other hand for aiming at the highest environmental impact possible because applying one option may not be sufficient:

1. Increasing the EU GHG reduction target to 30% in 2020
2. Early revision of the linear reduction factor
3. Retiring a number of allowances
4. Access rules to international credits
5. Discretionary price management mechanisms: carbon price floor or price management reserve
6. Extension of the scope to other sectors

### **Justifications and rationale of the ranking**

These recommendations are justified as follows:

#### **a) Increasing the EU GHG reduction target to 30% in 2020**

**Green Budget Europe is strongly in favour of increasing the general ambition level of Europe's climate policy. A GHG reduction target of 30% by 2020 is – together with the early revision of the linear reduction factor and its substantial further strengthening – the most comprehensive solution to tackle the current structural problems within the EU ETS and to put Member States on track to reach the 2050 long-term target.**

##### **1) Advantages**

Increasing the GHG reduction target is the most comprehensive option to revise EU climate and energy policy. It does not only tackle the current surplus of EUA as a symptom of structural problems but addresses the fact that the 20% target turned out to be unambitious due to

- generally low economic growth/ activity, mostly due to the recession which allowed MS to carry forward EUAs
- rising oil and energy prices which have increased efficiency measures and savings stronger than expected
- an unexpectedly strong inflow of international credits, allowing for high and relatively cheap offsets abroad
- the fact that studies showed that this is mainly representing the reference scenario which comprises no ambitious climate policies.

##### **Justification:**

As the 30% target results in a tightened ETS cap (i.e. 34% lower than 2005 emissions), this option allows for additional environmental and social benefits, i.e. beyond reductions related to the economic crisis. It secures a higher contribution of the ETS to reach the EU 2020 goals and releases those industry sectors where CO<sub>2</sub> reductions are much harder to achieve (i.e. buildings or transport).

It ensures that the ETS contributes to renewables and energy efficiency by delivering a significant price signal, yet still substantial other measures are necessary, too.

Raising general efforts goes beyond tackling the surplus and therefore allows EU to demand further commitments at international level. This would help to develop credible global leadership.

## 2) Constraints

Tightening the target requires an amendment of the quantity of allowances in the EU ETS. EUA could be either reduced by permanent retiring (option b) or by increasing the annual linear reduction factor (option c). This option also requires an adjustment of the targets defined in the Effort Sharing Decision.

## 3) CO<sub>2</sub> emission reduction and ability to meet the long-term target of 80-95% reduction cost-effectively

An increased overall emission reduction target demands further efforts via various channels, as the EU Climate and Energy Package would have to be revised

- tighter ETS cap reducing emissions by 34% on 2005 levels
- higher target for non-ETS sectors (-16%) according to the Effort Sharing Directive
- higher national targets for renewable energies

### Justification:

With an ambitious target, emission reductions result from higher energy efficiency and investments in renewable energy technology. Therefore, the cap leads to long-term/ strategic changes, whereas low emissions during economic recession only help in the short run and may lead to a high emissions trajectory until 2020.

Only a strong carbon price signal resulting from an ambitious target can internalise external costs and at the same time create incentives to engage in low carbon investment. This policy would ensure that European Member States are well on track to reach the 2050 long-term target and carry a fair share of the necessary reduction already today.

As avoidance of climate damage is proven to be less dependent on high reduction rates than on early action (Stern Review: The Economics of Climate Change)<sup>1</sup>, postponing strong targets reduces effectiveness.

## 4) Effects on employment and households

Low-carbon technologies tend to be more labour intensive than conventional sectors, and also increase energy security. Achieving a 30% reduction target reduces imports of oil and gas by some €40 billion in 2020, at an assumed oil price of US\$ 88 per barrel in 2020. Instead, investment would be geared to promoting green jobs in low-carbon technologies in the EU (European Commission, COM(2010) 265<sup>2</sup>).

### Justification:

Facing the effects of the current crisis, European governments are struggling to reduce major fiscal deficits without decreasing economic activity. Research shows that carbon fiscal measures have high potential for raising revenues at less detrimental macro-economic impact than other tax options or austerity measures.

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<sup>1</sup> <http://siteresources.worldbank.org/INTINDONESIA/Resources/226271-1170911056314/3428109-1174614780539/SternReviewEng.pdf>

<sup>2</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0265:FIN:en:PDF>

Regarding employment and losses in GDP, the ETS outperforms all other revenue raising instruments. Tightening the cap might create €30 billion of additional auction revenues per year across Europe (average carbon price of €44/t CO<sub>2</sub>). From 2013-2020, direct taxes generating the same revenues would lead to 50% higher losses in GDP and even 3 times higher losses in employment (see results of the Carbon and Energy Tax Reform in Europe (CETRIE) report by Vivid Economics<sup>3</sup>).

Potential recessive effects on consumers can be addressed in a very targeted manner by adjusting labour taxes and other accompanying measures.

A stronger carbon price signal incentivises investment of roughly €2 billion annually between 2013 and 2016, which is both favourable for GDP and employment.

## 5) Macro-economic costs and political calculation

In 2008, the costs of reaching the 20% target were estimated at €70 billion until 2020. However, as economic and technological circumstances have changed, the same funds would be sufficient today to take the EU more than half way towards stepping up from 20% to 30%. Today, the total cost of a 30% reduction, including the costs to go to 20%, is estimated at €81 billion. In comparison, sticking to the 20% reduction would lead to total costs of €48 billion (European Commission, COM(2010) 265<sup>4</sup>). If the target is tightened to 30%, it is estimated that the carbon price in the EU ETS will amount to some €30 per tonne of CO<sub>2</sub>, which is similar to the level estimated to be necessary to meet the 20% reduction target in 2020. Domestic emissions would reduce to -25% compared to 1990 with the remaining being covered by banked allowances and international credits.

Therefore, going to the 30% reduction target represents an increase of €11 billion compared to the absolute costs of the climate and energy package in 2020 as projected in 2008, while the carbon price would remain close to the expected level.

### b) Retiring a number of allowances

**GBE is strongly in favour of retiring 1.4 billion allowances immediately from the market. This measure does not only tackle the current structural surplus but also raises the ambition level by aligning the ETS cap with an overall reduction target of 30% by 2020. However, GBE stresses that backloading can only be seen as a short-term measure. In order to efficiently reach the 30% target, backloading can only be efficient in combination with one of the other options presented by the European Commission.**

#### 1) Advantages

This measure may align the ETS cap with an overall target of 30% if a volume of 1.4 billion allowances is retired.

#### Justification:

- Retiring EUAs allows to effectively and quickly tackle the supply-demand imbalance by reducing the surplus in phase III.
- Can be implemented in a very targeted manner, i.e. with relatively little impact on other legislation

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<sup>3</sup> <http://www.foes.de/internationales/green-budget-europe/gbe-projekte/cetrie/?lang=en>

<sup>4</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0265:FIN:en:PDF>

- Could be implemented by a separate decision instead of a full revision of the EU ETS Directive

## 2) Constraints

It implicitly increases the target for 2020, but does not affect the framework beyond. This option could thus be considered as a missed opportunity for a broader and long term oriented solution.

It is not clear if a backloading of 1,4 billion allowances as a stand alone measure without a combination with the other options would really reach the 30% goal.

Retiring allowances fails to address the too low target by an integrative solution as it only adjusts the target for ETS sectors but not beyond. Thus, this option does not guarantee the compliance with an overall reduction target of 30% by 2020. Sectors subject to the Effort Sharing Decision would be privileged if their overall reduction rate stayed constant.

If the retiring option is not linked to a higher target, it is very likely that it would be limited to the back-loaded amount of 900 million EUA. This volume is even not sufficient to remove the 2011 surplus of 1 billion allowances, which is expected to rise to at least 1.5 billion EUA by 2013 and 2 billion EUA by the end of phase III.

## 3) CO<sub>2</sub> emission reduction and ability to meet long term target of 80-95% reduction cost-effectively

GBE calls for permanently pulling 1.4 billion allowances from the market to tackle the surplus and thus ensure the orderly functioning of the carbon market and the delivery of a carbon price signal. Thus, backloading needs to be combined with other measures.

### Justification:

If the retired volume is too low (i.e. 900 million EUA), the price signal will remain too low to incentivise investments leading to a competitive low-carbon European industry.

Only removing the problematic surplus does neither allow to realise the full potential of the ETS as a powerful instrument to reduce emissions cost-effectively, nor to make the shift towards green growth that would be urgently needed in times of economic crisis.

## c) Early revision of the linear reduction factor

**GBE is strongly in favour of immediately raising the linear reduction factor to a level in line with the 30% target for 2020. This measure does not only tackle the current structural surplus but also puts Member States on track to reach the 2050 long-term target.**

### 1) Advantages

In order to ensure an adequate contribution of the ETS to the EU long term target, the ETS Directive foresees a review of the linear reduction factor coming into effect by 2025. This adaptation should be pulled forward to 2013 in order to reduce the accumulating surplus in period III.

However, an early revision should not replace a fundamental review in 2025 which will determine important framework conditions for long-term decarbonisation.

This option will be most efficient when implemented in combination with option a and/or b.

**Justification:**

By advancing the review and increasing the factor to a level in line with the 30% target, Member States would be earlier on track to reach the 2050 target because the share of the ETS sector will be secured. The average annual reduction could remain lower from 2025, as we would already today contribute a fair share of reduction efforts.

One of our major arguments in favour of a more tightened ETS policy is the urgent need of governments to consolidate their national budgets in a cost-efficient way and to enhance competitiveness of the industry by inducing green growth. Revenues arising from higher prices due to auctioning could be used accordingly (see results of the Carbon and Energy Tax Reform in Europe (CETRIE) report by Vivid Economics<sup>5</sup>

## 2) Constraints

Whether the carbon market can already benefit from the positive effects of this structural measure in period III largely depends on how soon it would come into effect. The co-decision procedure in European institutions could be an obstacle for a smart, quick and effective revision of the EU ETS Directive.

**Justification:**

As the revision of the linear factor strongly affects EU low-carbon policy beyond 2020, the scope and timeframe to be addressed would be strongly extended. This opens the potential to reach a more comprehensive solution, but on the other hand reduces the ability to react quickly on the current imbalance.

Therefore, the one should start with the first option (retiring) as this could be implemented quickly.

## 3) CO<sub>2</sub> emission reduction and ability to meet the long-term target of 80-95% reduction cost-effectively

If the factor is raised to a level in line with the 30% target for 2020, Member States would be put on track to reach the long-term target as well, provided all sectors, not only the ETS covered sectors, will have their share. Hence, this option is even better than option no. a) Increasing the EU GHG reduction target to 30% in 2020. In order to achieve a 95% reduction, the factor should need to be set significantly higher than the actual 1,74 p.a. The factor should be raised and adjusted in order to reach the 2050 targets.

**Justification:**

The linear reduction factor decreases the amount of allowances issued by 1.74% annually between 2013 and 2050. At its current level, it may only lead to a total reduction of 70% per cent by 2050, thus failing to meet the EU long term target of 80-95%.

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<sup>5</sup> <http://www.foes.de/internationales/green-budget-europe/gbe-projekte/cetrie/?lang=en>.

## d) Extension of the scope to other sectors

**GBE generally welcomes extending the scope of the ETS to other sectors. However, this is not a clearly targeted solution for the current structural problems within the carbon market.**

**GBE is especially against the inclusion of surface transport.**

### 1) Advantages

Extending the scope of the ETS to other sectors is welcomed as an important step in the further development of the European carbon market.

#### Justification:

As non-ETS sectors seem to be less strongly influenced by economic cycles (emissions decreased only by 4% in 2009 during the crisis, compared to 11% in ETS sectors), an expansion could rebalance supply and demand.

### 2) Constraints

This measure cannot be considered as a clearly targeted policy approach. The extension of the European carbon market is an important aim as such and based on profound argumentation related to economic, social and environmental benefits. However, there is no inherent link between the current ETS cap and excluded sectors for which a new cap would be set. New sectors should not be misused for reducing the structural surplus within the current scope.

Including new sectors requires analytical background work and time for implementation that might slow down the measure's deployment. In addition there is the danger of an over-allocation of certificates in the beginning which will distort the market and will not give the necessary long-term investment security that it needed for the industry. A targeted CO<sub>2</sub> tax might be much more efficient.

#### Justification:

While emissions trading has the potential to cover many economic sectors and GHG emissions, the focus of the EU ETS is on emissions which can be measured, reported and verified with a high level of accuracy. The relation between ETS and existing national policies required by the Effort Sharing Decision and in some cases (e.g. transport) the reporting obligation, would need to be clarified.

### 3) CO<sub>2</sub> emission reduction and ability to meet the long-term target of 80-95% reduction cost-effectively

Whether extending the scope of the ETS leads to further CO<sub>2</sub> reduction and whether it can contribute to the ability of reaching the 2050 target depends on the cap foreseen for new sectors.

#### Justification:

If the target is not set significantly above the reduction currently realised via national measures under the Effort Sharing Decision, we risk ending up without progress or even with a step backwards.

For the sake of transparency, the policy goals of quantity, i.e. the cap, and quality, i.e. the scope, should not be mixed.

#### 4) Effects on employment and households

The impact on employment and households largely depends on the sectors to be included.

#### 5) Macro-economic costs and political calculation

Depends on the design of the measure, i.e. the sectors to be included, potential exceptions and the level of the emissions cap foreseen.

#### e) Access rules to international credits

**GBE welcomes the amended wording of the EU ETS Directive, which provides stricter access rules to international credits from 2013. However, we do not believe that further restrictions might solve the structural problems within the carbon market because the measure does not allow removing the existing surplus. Furthermore, these are important bridges towards other countries and regions for climate policies which must not be endangered.**

##### 1) Advantages

Without international credits (CER from CDM and ERU from JI), the surplus in the ETS by 2020 would probably amount for only 25% of what is currently expected.

##### Justification:

ETS legislation allows using most categories of credits from the Kyoto Protocol's Clean Development Mechanism (CDM) and Joint Implementation (JI) for compliance. International credits can cover up to 1.7 billion tonnes of emissions between 2008 and 2020, which is equivalent to 50% of the reductions required in the EU ETS within that period. Total issuance of allowances and use of international credits minus emissions result in the build-up of a surplus.

The fact that by the end of 2011 just under one-third of the limit of international credits had been used up indicates that CER and ERU deliver significant comparative cost advantages. Considering the low EUA price within the same period, this situation requires stricter access rules, improving the quality of investment in terms of economic and environmental benefits.

Limiting the access to international credits both in quality and quantity would require higher efforts and keep a greater share of clean technology investment in Europe. The regulatory framework for phase III already foresees qualitative restrictions on certain types of international credits for compliance use.

##### 2) Constraints

Effects of a change in the regulatory framework regarding international credits would not deploy before phase IV. Therefore, this measure would fail to address the downward pressure on prices in the second half of phase III, when the back-loaded allowances re-enter the market.

Further restrictions might not be justified, taking into account the incentive for investment and technology transfer to developing countries.

##### Justification:

From 2013 onwards, concerns regarding the effectiveness of credit-generating projects in combating climate change are addressed by significant restrictions on the type and number of international credits permissible for the EU ETS. This results from the amended wording of the EU ETS

Directive, which provides that credits must “represent real, verifiable, additional and permanent emission reductions and have clear sustainable development benefits and no significant negative environmental or social impacts”. Thereby, the EU Commission has already taken the correct approach in placing clear limits on the usability of Kyoto credits, which now depends on environmental quality and provenance.

### **3) CO<sub>2</sub> emission reduction and ability to meet the long-term target of 80-95% reduction cost-effectively**

From a long-term perspective, it is crucial to keep a high share of emission reduction in Europe in order to ensure clean technology investment in sectors that have already reached a relatively low emission level.

#### **Justification:**

The 2020 target can't be solely met by comparatively cheap reduction in developing countries but demands substantial progress in Europe. Using up permissible credits today results only in postponing Europe's "homework" and wasting valuable time for technological development and investment.

The amendment of the ETS Directive integrating stricter access rules for international credits already addresses major shortcomings. Further tightening can definitely not tackle the structural surplus at its root without decreasing cost-effectiveness, as international credits are an important tool to contain compliance costs.

### **4) Effects on employment and households**

A stricter regulatory framework would promote domestic investment in low-carbon technology and hence reduce transfer of funds and technology to third countries. For this reason, a lower share of international credits might improve Europe's employment situation.

### **5) Macro-economic costs and political calculation**

Limiting the access to international credits decreases cost-effectiveness in terms of GHG reduction, as international credits are an important tool to contain compliance costs. However, if the potential return on money invested remained in Europe, this option might even lead to an overall net benefit for Europe's economy.

### **f) Discretionary price management mechanisms: carbon price floor or price management reserve**

**GBE considers price management mechanisms as effective instruments for market stabilisation. However, if implemented, they should only be used as accompanying measures to a structural solution, i.e. options a, b or c. High reliance on price management provokes contradictions with characteristics of the ETS and risks economic efficiency. Then the task sharing between ETS and energy pricing and taxation would need to be revised generally.**

#### **1) Advantages**

A carbon floor price fixing a minimum price level for the auctioning process or a price management reserve stabilizing the supply-demand balance can prevent price drops, reduce volatility and increase certainty for investors and technology suppliers.

**Justification:**

Both instruments (fixing a minimum price level or a price management reserve) are mechanisms for flexible price management in response to the current market situation.

A minimum price may ensure the internalisation of a certain share of external costs. A price floor would therefore allow combining the advantages of emissions trading (quantitative target reached cost-efficiently) and a carbon tax (pre-determined minimum price).

The implementation of a price floor as a reserve auction price higher than the current level might be a smart option to ensure a pre-determined minimum without fixing a carbon price, even if the floor is exercised. However, this measure does not reduce the need for a tighter target and should be considered as a complementary tool only increasing stability.

**2) Constraints**

Price Management fails to address the too low target by an integrative solution as it only adjusts the symptom of a low carbon price in the short term. As a result, this option may lead to an orderly functioning system but not to an additional environmental benefit.

**Justification:**

Price management in principle is in some conflict with the nature of the EU ETS, which as a quantity based instrument allows for predictable emission reductions in a cost-effective manner but not for a predictable price. However, it is potentially a good complement to a malfunction of the EU-ETS which is currently the case.

Price management as such has many advantages from an environmental and economic point of view. However, it does not allow meeting the reduction target at the lowest cost possible, as the ETS does. If price management is integrated, emissions trading could lose its ability to reach the reduction target most cost-effectively as foreseen by the Commission. However, the price management ensures that price signals are given now and thus preparing enterprises with higher future prices better than the currently very low price level. It thus supports the anticipation of higher prices in the futures which are very certain to come. And this is crucial so that long-term investment cycles are not missed to incentivise ambitious investment. They only emerge every few decades, particularly in the area of energy infrastructure.

Additionally, a price floor leads to operational challenges when it comes to linking the EU ETS to other international schemes.

**3) CO<sub>2</sub> emission reduction and ability to meet the long-term target of 80-95% reduction cost-effectively**

Price management jointly with a malfunctioning ETS supports the ETS as long-term investment cycles are addressed and the moment will not be missed when investments have to be decided upon.

Price floors can influence the long-term goals: If the prices of the EUAs are too low and if investments are not realised, it will be very hard to implement ambitious goals in the future.

**Justification:**

If the price was (too) low due to a malfunctioning of the EU-ETS, the required investments in renewable energies and energy efficiency would not be made, but instead the investor would rely on a too low ETS price and then invest in carbon intensive technologies which would also present an economic risk once the EU ETS had recovered and regained its original function back again.

#### 4) Effects on employment and households

Stable market conditions increase certainty for investors. But it is exactly the lack of price stability of the ETS which is addressed by the carbon floor price, hence this is a positive aspect.

A higher CO<sub>2</sub> price might increase the incentive for low-carbon technology investment, which tends to be more labour intensive than conventional sectors. However, the chance to reach positive net-effects depends on a smartly set level of the price floor.

#### 5) Macro-economic costs and political calculation

A price floor mechanism could lead to higher than necessary abatement costs because if the floor price is exercised, this implies that abatement could have been achieved at a price lower than the floor price, and targets could have been met at a lower overall cost.

Introducing a price floor leaves the carbon price subject to current political will and strategy. Facing an economic crisis, a strong commitment to climate policy from all Member States is very unlikely. Therefore, we risk locking climate policy at a low ambition level if we only cure symptoms by adjusting the carbon price as a single, isolated measure.

On the contrary, raising the reduction target causes scarcity that mainly results in a strong price signal when economy recovers. For these reasons and given that businesses are generally more in favour of market mechanisms, price management is a supportive market-based instrument which brings us closer to a comprehensive solution in which the EU ETS regain its full functioning.