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Position Paper
Eurogas views on the EU
Emissions Trading System and
the Market Stability Reserve



Eurogas is the association representing the European gas wholesale, retail and distribution sectors. Founded in 1990, its members are 44 companies and associations from 24 countries.

Eurogas represents the sectors towards the EU institutions and, as such, participates in the Madrid Gas Regulatory Forum, the Gas Coordination Group, the Citizens Energy Forum and other stakeholder groups.

Its members work together, analysing the impact of EU political and legislative initiatives on their business and communicating their findings and suggestions to the EU stakeholders.

The association also provides statistics and forecasts on gas consumption in Europe. For this, the association can draw on national data supplied by its member companies and associations.

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Eurogas views on the EU Emissions Trading System and Market Stability Reserve

Key messages

- The Emissions Trading System (ETS) is the most cost-effective tool to reduce Europe's greenhouse gas emissions, and at the same time increase energy efficiency and the share of renewable energy sources in the fuel mix.
- The current surplus of ETS allowances was generated by a number of factors, which had not been considered when the ETS legislation was adopted. This oversupply of ETS allowances has led to much lower-than-expected prices for emissions allowances, which do not provide an incentive for emissions reductions.
- To maintain the ETS as an optimised tool it urgently needs to be reformed, before both the market and governments lose faith in it.
- The concern about the impact of higher prices on EU competitiveness in the absence of an equitable global agreement also needs to be addressed.
- The proposed Market Stability Reserve, which allows surplus ETS allowances to be set aside until needed, is a sound measure for addressing the deficiencies of the ETS.

Given the current state of the ETS market, the above-mentioned reform is needed urgently and therefore we would seek early agreement among the institutions on the proposed reform. However, the introduction of the Market Stability Reserve in 2021 alone is too little too late. The following four key improvements are required:

- i. Introduce the Market Stability Reserve in 2017.**
- ii. Place the 900 million allowances that have been back-loaded straight into the Market Stability Reserve.**
- iii. Shorten the period from assessment of the surplus to use of the reserve from 12 months to six months.**
- iv. Bring forward the proposed review date from 2026 to 2022. This review must take into account the views of those parties which are actively hedging on the ETS market.**

The EU Emissions Trading System and its global context

The technology-neutral approach of a target for greenhouse gas (GHG) emissions reduction, in connection with a well-functioning ETS and effective measures in non-ETS sectors, provides the best solution to enable each low-carbon option to be used where it is most cost-effective. This approach allows all technologies to compete on a level playing field and/or team up with others; for example, gas/renewable hybrid solutions.

For EU action to be successful it should be part of a global effort. The commitment by the European Council for a greenhouse gas reduction target of at least 40% by 2030 should direct the negotiating position of the EU towards a 2015 global climate agreement.

The goal for the EU should be an international agreement whereby the EU's trading partners make an equivalent effort, meaning that carbon leakage measures will no longer be needed. As long as the EU's international trading partners do not make equivalent efforts to reduce GHG emissions, carbon leakage will remain an important issue and direct as well as indirect additional costs to companies exposed to global competition should be addressed. This topic should be dealt with comprehensively in the follow-up to the Council decisions on the 2030 climate and energy policy. Free allowances should be allocated on the basis of evidence provided by the sectors concerned.

Important Reform Measures to the ETS

1. Increase the linear reduction factor

The Council proposal to increase the linear reduction factor (the annual rate of reduction in ETS allowances auctioned to the market) from 1.74 % to 2.2% for the ETS sectors from 2021 is necessary to put Europe on track towards a 40% GHG emissions reduction target.

2. Introduce a Market Stability Reserve

The ETS requires a market stability reserve, which will allow surplus ETS allowances to be set aside until needed.

3. Exclude the use of new international credits

Excluding the use of new international credits in meeting the greenhouse gas emissions reduction target is a sensible course of action and shows that a lesson from the 2020 policy framework has been taken on board. The proposed approach of using international credits, if the EU chooses to go beyond a 40% greenhouse gas emissions reduction target because other international partners provide meaningful ambitions, is also a sound proposal. Were this to be the case, the current system for using international credits would require an overhaul to prevent a repeat of undesirable experiences.

4. Add new sectors to the ETS

The addition of new sectors to the ETS should be considered to the extent that their current emissions and emissions reductions are fully verifiable and their inclusion is practically feasible.

The Market Stability Reserve

While the ETS is the most cost-effective tool to reduce greenhouse gas emissions, the oversupply of ETS allowances and a much lower-than-expected allowance price have not provided a strong incentive for emissions reductions. In the power sector, the low price of ETS allowances, together with the low global price of coal, the high influx of subsidised renewables and a lack of market mechanisms to reward the flexibility of gas-fired power stations, has led to the economics of coal-fired power stations being more favourable than those of gas-fired power stations. This results in the power sector not achieving the emissions reductions that would otherwise be possible and carbon dioxide emissions rising again in some Member States.

Against that background, the Commission's proposal for a Market Stability Reserve, which allows surplus ETS allowances to be set aside until needed, is a sound approach to reducing a surplus of ETS allowances that jeopardises the functioning of the ETS, and to addressing economic development and EU competitiveness at the same time. The smoothing mechanism to be used between trading periods, in order to avoid a large step-change in the number of allowances to be auctioned between two years, is also a sound proposal. This reform is needed urgently and therefore we would seek early agreement among the institutions on the proposed reform.

However, as the Commission's own analysis shows, these proposals do not have a material impact on the ETS surplus until well into the middle of the next decade. The current surplus of ETS allowances is considerable, and waiting until 2021 for any further meaningful action could be too late.

There are four key improvements which would ensure that the Market Stability Reserve functions to its optimal potential.

1. Start date of Reserve in 2017

Earlier measures that address this oversupply issue are necessary and the Market Stability Reserve should commence from 2017¹ and not 2021 as proposed by the Commission.

2. Back-loaded allowances straight into the reserve

The 900 million allowances that have been back-loaded should be placed straight into the Market Stability Reserve, rather than being released back to the market in 2019 and 2020 as currently proposed by the Commission.

¹ For the avoidance of doubt, this refers to the date that the allowances are first allocated to the reserve (2021 in the current Commission proposal), rather than the date of first verification of the surplus, which would be April 2016.

3. Shorten the timing of the annual activation of the reserve

The Commission proposes that the movement of allowances to and from the Market Stability Reserve should start 12 months after the year in which the number of surplus allowances is verified. However, verified emissions of year n are known by 31 March year $n+1$ and the compliance process normally ends by 30 April of year $n+1$. Therefore, the period could be shorter with allowances moving to and from the reserve starting six months earlier, from the second half of year $n+1$. Such a mid-year amendment has been carried out before, when the back-loading of ETS allowances commenced.

This shortening of the period between the assessment of surplus allowances and the transfer of allowances to/from the reserve will bring the reserve more in line with ETS market conditions and hence make it more robust.

4. Commission's Review of Mechanism

An earlier introduction of the Market Stability Reserve would also necessitate an earlier introduction of the review clause, which requires the Commission to submit a proposal, where appropriate, to the European Parliament and European Council. The date currently proposed by the Commission to complete the review is by the end of 2026, but this should be brought forward to the end of 2022. This would maintain the Commission's proposal for a five-year period between the introduction of the mechanism and the review, thereby ensuring that there is sufficient time to build understanding of the workings of the mechanism in order to facilitate a review.

The trigger levels for injecting and withdrawing allowances from the ETS (proposed as 833 million and 400 million allowances respectively) need to be adequate to ensure that ETS participants can hedge their forward needs of ETS allowances. Triggers that are too low will damage the hedging ability of companies, but if they are too high it could reduce the effectiveness of the mechanism. Determining what these might be is rather difficult, given that the hedging strategies will differ from company to company and will also evolve over time. We would like to emphasise, therefore, the importance of the review clause, which must take into account the views of those parties which are actively hedging on the ETS market.

The review of the mechanism should also specifically consider the following:

- the rate of injection of allowances from the surplus into the reserve; considering that accelerating this injection rate might repair the ETS sooner, most likely resulting in avoiding a call for more additional measures in the ETS sectors or even national measures, as has been seen in some Member States to date;
- the withdrawal rate of allowances from the reserve; considering that accelerating the withdrawal rate might prevent possible rapid price increases in the future, since this could threaten the political acceptance of the instrument.

Changes to the triggers or injection and withdrawal rates should be supported by publically available information and analysis.