

The European Commission Proposal for a Market Stability Reserve in the European Emission Trading System

October 2014

Key messages

- CEDEC supports the Communication for a European Climate and Energy Framework for 2030 and the inherent target to cut greenhouse gas (GHG) emissions by 40% in 2030 and the implication **to increase the linear reduction factor in the ETS after 2020**.
- We moreover take note of the accompanying proposal for a decision for **the introduction of an ETS Market Stability Reserve (MSR)** as an instrument to increase the supply flexibility and react to external shocks such as the recent European economic crisis. However, to increase the effectiveness of the mechanism, CEDEC proposes some adaptations.
- In order for the ETS to perform as a policy driver for low-carbon investments, we believe the ETS has to generate a carbon price trajectory which can impact both on operational decisions for existing installations, and on capital investment decisions for new installations. Therefore, the set-up of an MSR should be accompanied by short-term measures with immediate effect. CEDEC therefore believes that **the planned start of operation of the MSR in 2021 is coming too late** to address the current supply and demand imbalance in the ETS. The current oversupply of European Union Allowances (EUAs) would only be slowly decreased by an MSR in general and starting too late. Therefore, CEDEC believes that the MSR should be start to operate already in 2017.
- Moreover, CEDEC believes that at least the **900 million currently back-loaded EUAs, should not be re-introduced in to the market**, in order to have a short-term effect on the carbon price. Preferably, the certificates are permanently deleted, or otherwise, directly moved into the MSR in 2017.

Introduction

CEDEC believes in the ETS as an important instrument to reduce GHG emissions and reach the European climate and energy targets. For local energy companies, the ETS is a crucial driver for investments in low-carbon technologies, such as renewable energy installations, energy efficiency and demand-side flexibility measures.



Investment signals deriving from the ETS have been very low recently, due to the massive oversupply of carbon allowances, caused by the recent economic crisis as well as the large influx of international credits, which led to almost negligible price levels for CO₂ emissions and consequently low incentives to invest in clean technologies. The current surplus of more than 2 billion EUAs is projected to reach more than 2.6 billion by 2020, promising no improvement of the situation.

Market Stability Reserve

CEDEC believes that the proposal for a Market Stability Reserve first of all is an important **political signal to restore the credibility of the ETS**. Moreover, the reserve, to which EUAs will be moved instead of auctioned in the market at time of oversupply and released from it when demand exceeds supply is in line with the **market-based set-up** of the instrument. Due to the clear rules and independent oversight, the MSR will add to the **predictability and transparency** of the ETS.

According to the European Commission proposal, two main objectives are addressed with this proposal. First, to remedy the current surplus of allowances, and second, to create an instrument which makes the ETS more resilient to any future external shocks that might create imbalances in demand and supply.

With regard to the second objective, CEDEC appreciates the Commission proposal and believes the **MSR adds robustness to the ETS**. In the event of another economic crisis the system would be able to react more flexibly to sudden drops in demand.

However, with a view to the first objective, to remedy the current surplus, CEDEC believes that the MSR will have only little impact that is moreover coming much too late. With a surplus of more than 2.6 billion EUAs in 2020, this will only be decreased gradually by moving certificates to the reserve. While in addition the linear reduction factor will be increased after 2020 in line the binding 40% GHG reduction target for 2030, CEDEC believes that both measures will have insufficient impact on the current surplus in the system. From a local energy company point of view, it is essential that a reform of the ETS leads to a price signal that has an impact on the merit order and therefore rewards the operation of and the investment in low-carbon technologies.

Therefore, to serve both objectives, CEDEC suggests to **introduce the MSR in 2017**, coinciding with the end of the back-loading period. Introducing the MSR in 2017 means that the surplus will be calculated in 2016 and the volume of allowances will be reduced already from 2018 onwards. Furthermore, **we recommend to not re-introduce the currently back-loaded certificates in the market**. Instead, CEDEC would like to see the **900 million back-loaded certificates, and ideally more, close to the current surplus, to be permanently retired**. This option is the most effective and simple measure to create a better balance of demand and supply, which leads to a carbon price that will drive low-carbon investments.

CEDEC agrees with the European Commission's conclusion in the accompanying impact assessment that this dual approach would be "consistent with the dual nature of the problem, which is on the one hand the large surplus that the market is experiencing today (a "corrective" element) and on the



other hand possible re-emergence of imbalances in the future due to large demand shocks (a “preventive” element).

As a minimum, if there is no political will to permanently retire the back-loaded allowances, they should be **directly transferred into the MSR**, to avoid a large influx of certificates at the end of the third trading period.

Proposed adaptations of the MSR

Permanent deletion of certificates

Apart from the above-mentioned two-fold approach, CEDEC suggests some further changes to the MSR. To add to the effect of the ETS, CEDEC suggests to delete certificates from the reserve when a certain threshold has been surpassed for a longer time. The reason for this deletion is founded in the anticipated behaviour of the market. If the certificates remain in the reserve for several years, actors assume that they will be released to the market and therefore the price effect would fail to appear. Hence, a permanent deletion of certificates above a threshold that is to-be-defined, would add to the stability of the system.

To be emphasized in this regard should be that the threshold should be surpassed for a longer period of time (to be defined) to ensure that it is not a short-term shock. The objective of the ETS is to reduce emissions and therefore the need for certificates on an ambitious but predictable trajectory. The threshold should therefore be set in a manner that short-term emission increases as a result of high economic growth can be accommodated while no uncontrollable increase is supported by the MSR.

Review of MSR

The Commission proposes a regular review of the MSR. We appreciate this proposal as this will allow for a short-term learning effect as well as a chance to react to substantial changes in the market. The measures could reduce the insecurity about the upper and lower threshold of the MSR. However, we are skeptical that a regular review of the system is necessary. Instead some triggers could be defined to initiate the review. According to Art. 29a Emission Trading Directive (2009/29/EC): “If, for more than six consecutive months, the allowance price is more than three times the average price of allowances during the two preceding years on the European carbon market, the Commission shall immediately convene a meeting of the Committee established by Article 9 of Decision No 280/2004/EC”. This way, a drastic and lasting price decrease or increase would have to be considered. If the thresholds work, no review is necessary.