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## **E.ON Position on the proposed Market Stability Reserve - MSR**

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E.ON supports the European Emission Trading System – EU ETS – as the flagship instrument to deliver on the EU's climate policies and ambitions - not only for 2020 but also for 2030 and 2050 - in an efficient, market-oriented way. In order to re-establish the functioning and credibility of the EU ETS E.ON supports the proposal to introduce a MSR in principle.

To increase its effectiveness, however, E.ON suggests the following amendments:

- The MSR should start in 2017 in order to smoothen auction volumes over time.
- All backloaded allowances should be directly transferred to the MSR.
- The inflow of allowances into the MSR should be increased, also to counteract any calls for short-term additional and often counterproductive national CO<sub>2</sub> regulation.
- Although there is no clear formula for setting the upper and lower intervention thresholds or the re-injection volume, the reinjection volume should be increased to prevent possible rapid price increases in the future since this could threaten the political acceptance of the instrument.



## **The case for a Market Stability Reserve (MSR)**

**The MSR supports the political acceptance and environmental effectiveness of the EU ETS in line with the principle of backloading in order to restore the functioning of the market.**

The EU Emissions Trading System (ETS) is facing a structural crisis. Having begun in 2005 as an EU-wide market-oriented cap-and-trade system, the last couple of years have revealed structural weaknesses and its failure to produce long-term price incentives to support the EU's long-term climate goals in an efficient manner. The so-called backloading decision to temporarily take out 900 million allowances (EUAs) out of the market was a first attempt to restore the functioning of the ETS and to restore political confidence in this instrument. Unfortunately, though the EU ETS is a market-based instrument it will always be vulnerable to political interference since it is, by its very nature, driven as much by political interference as it is by market fundamentals. Furthermore, it is highly vulnerable to external economic shocks, as well as to implications caused by complementary policy measures. At present, the carbon market is the only market where the supply side does not (can not) react to price developments due to the existing political nature of the market.

To re-launch the EU ETS as a market-based instrument, the MSR provides some fundamental reanimation tools based on:

**Acceptance** which is twofold: It aims at both European and national trust in the effectiveness of emissions trading by preventing counteraction in form of national instruments like emission performance standards (EPS) or taxes, for example. Acceptance is also the main pre-condition for any investor confidence in this market.

Following the CO<sub>2</sub> price erosion and dull prospects of the EU ETS, many financial sector players (big institutes, as well as smaller, specialized trading companies) left the EUA market leaving the energy sector with less counterparties for hedging purposes. Now the CO<sub>2</sub>-market is drying-out. The liquidity is being reduced dramatically; despite a brief surge in trading activities due to backloading. Less liquidity results in higher price volatility and increasing overall sensitivity to the related political discourse. The backloading experience has shown that any one-off political intervention in the market will be viewed critically, so that a rule based mechanism like the MSR is likely to prove more acceptable than any other institutional based arbitrary mechanism, such as a central carbon bank, for example.

**The MSR would re-establish much needed confidence in the EU ETS which is urgently needed by both policymakers and market participants in order to reassure all stakeholders of the EU's credibility in terms of setting and reaching climate targets, and moreover, the ability of markets to deliver on these targets.**

**Environmental integrity** – Current low price levels are not delivering significant environmental benefits.

Despite almost unattainable fuel-switching price levels (IEA estimates 60 USD / t CO<sub>2</sub> in WE02013) in the power sector, an increasing price trend is environmentally effective. At present around 50 GW of plants built after 2000 in the EU are – for many reasons – not economically viable despite being needed for a low carbon transition since, a large number of coal-fired power stations will be retired over the coming years due to EU regulation like the Industrial Emissions Directive.



**The MSR helps to ensure a gradual increase in price which in turn, should help keep much needed low carbon fossil fuel installations on-line in the interim and lifting some still remaining low hanging fruits of abatement.**

### **The need for early implementation of the MSR**

**The MSR should start no later than 2017 to further stabilise the market after backloading 900 Mt.**

The MSR plays an essential part in the necessary future reform of the EU ETS. This reform will need to consist of a re-alignment of the annual linear reduction along with further carbon leakage provisions to help prevent carbon intensive industry from divesting in Europe. The MSR has to start ahead of the IV trading period - before any such provisions are to be introduced - in order to restore the functioning of the market in the meantime.

One of the lessons we have learnt by looking at the structural problems of the EU ETS is its lack of flexibility to help it deal with demand-side shocks (such as the economic crisis in 2008) and its inability to react on the supply side to either new long-term political targets (EU Low Carbon Roadmap 2050) or the interaction with complementary policies (RES support or energy efficiency schemes). Whilst backloading provided us with the necessary time to discuss all possible structural reform options, the re-introduction of the 900 million allowances in 2019 and 2020 will certainly lead to another price collapse in 2018. Many low carbon power plants would then be driven out of the market and the financial gap to renewables investments would be further widened.

From a market functioning perspective – or even a purely logical perspective - it does not make sense to increase the surplus before reducing it again. This is the reason why the European Commission has suggested an overlapping period in its Impact Assessment: to avoid market malfunction from reoccurring.

**Given that the very basis of implementing the MSR is “to ensure the orderly functioning of the market” we believe that the MSR should not only be brought forward and commence no later than 2017 but that the backloaded amount of 900 Mt should also be transferred directly into the MSR. It is for this reason that we strongly advocate for an early agreement amongst the institutions at the very latest by the end of 2015.**

### **The need for revising the set parameters**

**We believe that the extraction rate should be higher than 12% of the volume in circulation in order to decrease the current surplus at a faster rate and to send a clear message to the market. This is of particular importance in case the 900 Mt back-loaded allowances were not transferred into the reserve before returning to the market. Whilst we believe that the upper intervention threshold may be sufficient even for estimated hedging purposes, re-injection volumes should be somewhat increased to exceed the proposed 100 Mt in order to prevent any possible future price spikes.**

There is no easy and straightforward algorithm to determine an upper / lower band along with the ideal extraction rate since they are all interconnected and tied to assumptions of future hedging behaviour by the European power industry.



Determining any future hedging volume is a difficult task since different market strategies of different companies may result in different volumes and structures. The increase in generation from renewable energy sources and the pace of market liberalisation in Eastern Europe, for example, will have significant effects on those numbers. In our experience - without disclosing any own estimates of our future hedging policies - the European Commission's approach of 833 Mt seems reasonable despite the lack of clarity on how it was derived.

By contrast, market analysts assume that a higher rate of extraction than the proposed 12% might serve better the MSR's overall purpose which is to re-establish a functioning EU ETS as soon as possible. Building up the MSR faster would support keeping low carbon capacities in the market while pressing more carbon intensive ones out. Furthermore, a higher extraction rate with a corresponding increase in the CO<sub>2</sub> price would support EU and Member States' RES policies in the interim to 2050 by closing the financial gap for the EU's energy transition.

The argumentation for the lower intervention band of 400 Mt is similar to that of the upper limit. Given the uncertainty of future hedging policies the number may well be acceptable, although again, it is not clear where the European Commission derived it from.

In the course of the next couple of years many old, less efficient power plants will leave the market for economic and environmental reasons. Since only few new build plants will come online, mid-term abatement will need to be delivered by existing power plants. Given non-favourable international fuel prices, abatement through fuel switch possibilities might be lower than previously estimated. This results in steeper abatement curves as fewer abatement possibilities exist in the mid-20s. Indeed, by then the shorter EUA market as result of building up the MSR coupled with a steeper abatement curve could mean that the envisaged 100 Mt release amount p.a. for the MSR might not be sufficient to dampen any rapid CO<sub>2</sub> price increase. Such price hikes, in turn, could trigger unexpected political intervention. Thus, a higher release number of EUAs may be necessary to deal with possible market shortages and related price increases.