

ENVI's draft MSR report – an analyst's assessment

Summary

A draft report on the Market Stability Reserve by the Parliament's Environment committee proposes a transfer of backloaded allowances to the reserve while keeping the start date at 2021. In addition, ENVI's rapporteur Ivo Belet proposes to use 30 million allowances from the reserve for funding low-carbon technologies in the industry sector in any given year the MSR accumulates more than 400 million allowances. This provision could channel around 7.1 billion euro to industry sectors between 2022 and 2030. Furthermore, Mr. Belet's proposal suggests shortening the time-lag between calculating the market surplus and operating the stability reserve to one year.

Mr. Belet's draft report for amending the MSR seems to strengthen the Commission's proposal through the transfer of the backloaded allowances into the reserve while keeping an eye on industrial competitiveness.

Our model suggests that Mr. Belet's proposal for the MSR would result in carbon prices staying at around €10/t until 2020, and reaching €33/t in 2030. We find that Mr. Belet's proposal combined with an early start date in 2017 would reduce an additional 271 million tons of CO₂ emissions. Implementing the MSR only in 2021 delays this abatement into the future when it will likely come at a higher cost.

Analysis by Point Carbon's EU ETS analysis team

Introduction - Ivo Belet's version of the Market Stability Reserve

A draft report by the rapporteur Ivo Belet responsible for the Market Stability Reserve (MSR) file in the Parliament's Environment committee (ENVI) has been circulated. The highlights of the draft report are summarized as follows:

- Start date as Commission proposal (2021)
- Transfer of 900 million backloaded allowances directly to the reserve
- Funding of low-carbon technologies in industry sectors by making 30 million allowances available each year the stability reserve exceeds 400 million allowances
- Shortening the reaction time of the reserve to one year
- Review of the MSR within after three years of operation rather than six years as proposed by the Commission
- Maintaining threshold levels and withdrawal/return rates as in the Commission proposal

The report was released shortly after the Industry and Energy Committee (ITRE) had a first exchange of views on the MSR based on the draft report tabled by ITRE's rapporteur Tajani. The concerns of many MEP's over European competitiveness and the risk of carbon leakage were again raised during the ITRE

debate, and Mr. Belet's draft ENVI report comes across as an attempt to balance such concerns over higher carbon prices with an overall aim to reform the ETS and to improve the long-term cost-effectiveness of the scheme.

In the draft ENVI report, Ivo Belet suggests to **transfer the backloaded allowances** directly into the reserve. This is the most significant change from the Commission proposal. He explains that it would be "illogical" to have 900 million allowances returning to the market in 2019 and 2020 only to place them into the reserve again over phase 4.

In the report the **start date of the reserve is maintained at 2021**, but Ivo Belet mentioned during a discussion of the Parliament's Industry committee (ITRE) that he awaits amendments to the report by his colleagues and that the outcome of this process could also be an early start. Furthermore, his report proposes to maintain the threshold levels as well as take-out and release rules as proposed by the Commission.

The main innovation compared to the Commission proposal is to "**set aside**" **30 million allowances** every year after the market stability reserve has accumulated more than 400 million allowances (Amendment 8 of the ENVI draft report). Revenues from this 'extra-supply' would be used to finance low-carbon technologies and processes in the industry sectors. Such set-aside for funding industry innovation will take effect in 2022, as the reserve will hold more than 400 million allowances already in 2021, when the backloaded allowances are transferred to the reserve. Until 2030, we expect this mechanism to channel around 7.1 billion euro towards industry sectors. The draft ENVI report leaves it unclear how these allowances would be monetized. The report says that "in any year [...] 30 million shall be set-aside and made available". We interpret this as an annual selling of 30 million allowances to the market. Given the reference made to the NER300 decision, we expect the European Investment Bank (EIB) to act as facilitator.

Mr. Belet further proposes to **review the MSR within three years** of operation instead of six years as proposed by the Commission. The rapporteur argues that uncertainty remains over parameters such as MSR trigger levels (proposed at 400 and 833 million allowances by the Commission) and therefore, a "well-timed" review is essential.

Furthermore, Mr. Belet mentions that the two-year **time lag** foreseen for triggering the MSR as currently proposed by the Commission should be shortened to one year. This could prove difficult as verified emission data only becomes published in May following the relevant year. If the MSR would use last year's emission data for this year's operation of the MSR, auction volumes could be adjusted only between July and December. It is debatable if such procedure is sensible, as this will result in a significant difference between the auctioning volume in the first and the second half of the year. One possibility to overcome this dilemma would be the use of verified emission data in May to adjust the auctioning volumes between July this year and June next year. As the draft report is not specific on the exact timing during the year, we apply this more sensible assumption in our modeling.

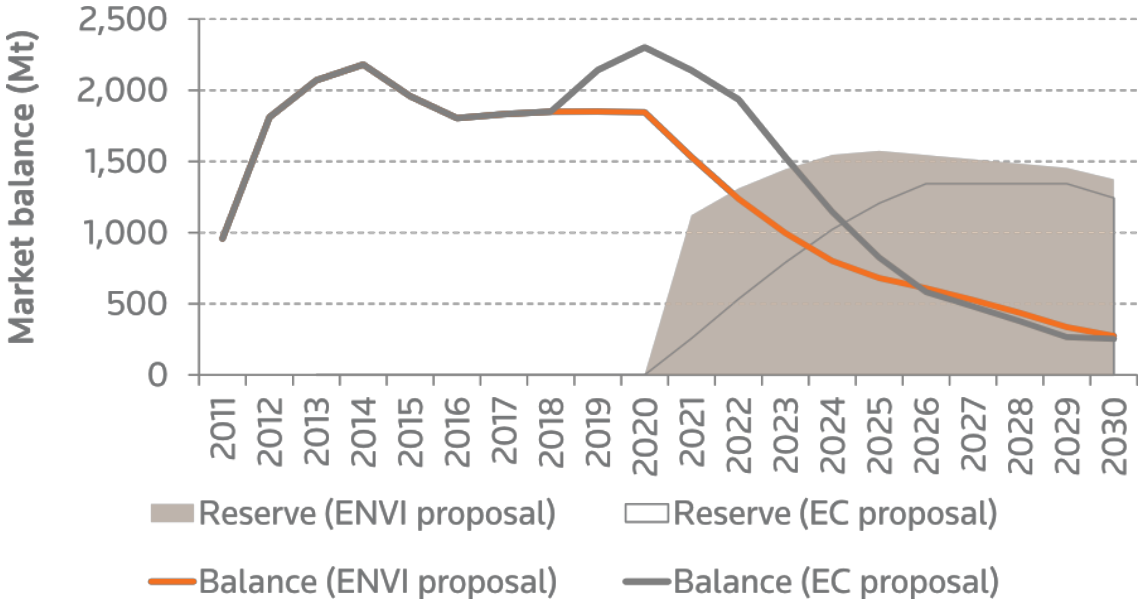
The expected effect of the MSR in the form of increased carbon prices ties the MSR discussion to the carbon leakage debate. Mr. Belet, however, argues for a clear procedural cut between the MSR decision

making process and the wider implementation of the 2030 framework. He acknowledges the need to give certain industry protection against carbon leakage post-2020, but argues that the European Council conclusions give such reassurance. Partly to accommodate the concerns of industry, Mr. Belet suggests a six month deadline for the Commission to come forward with a legal proposal reviewing the ETS Directive after the MSR regulation has entered into force. This is to account for post-2020 carbon leakage provisions and more flexible free allocation methods as mentioned by the 2030 Council conclusions on the energy and climate framework.

Implications of the draft ENVI report for the market balance and carbon prices

We forecast that under Mr. Belet’s proposal the market will remain substantially oversupplied until 2020 (see Figure 1). Our model estimates that in 2020 the market surplus will reach almost 1,900 million allowances. This is a lower oversupply than the one that would result from the Commission’s MSR proposal, as Mr. Belet’s report proposes that the 900 million backloaded allowances be transferred to the reserve. From 2021 onwards, the market oversupply is projected to begin declining as the MSR takes effect. We estimate that by 2030, the accumulated market balance will be 274 Mt.

Figure 1: Market balance – comparison of ENVI and Commission proposals

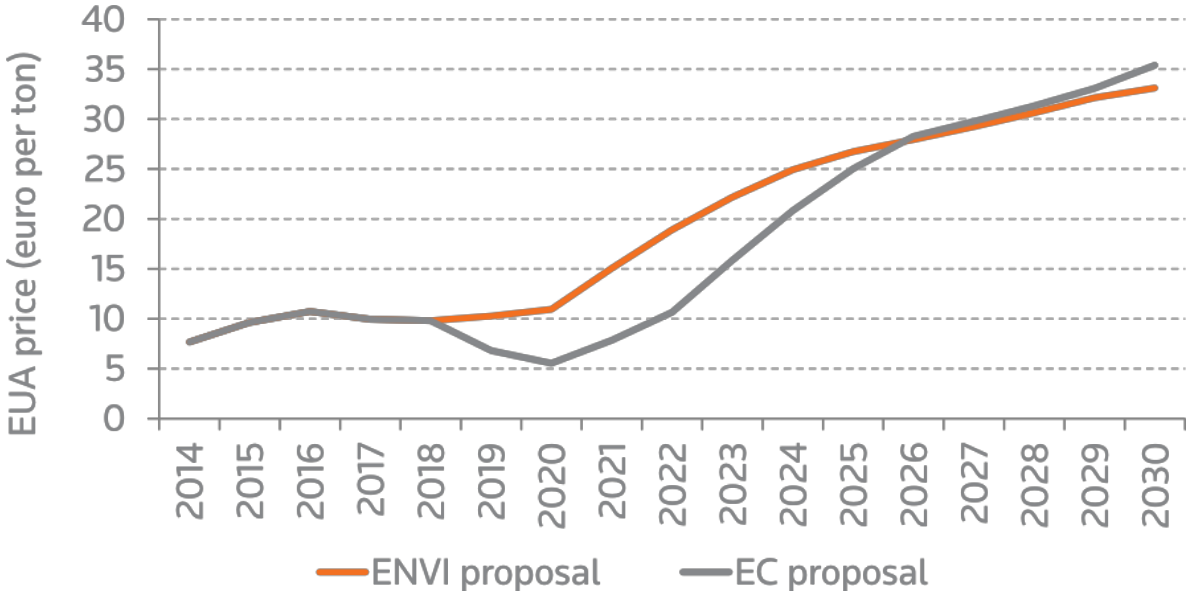


As a result of Amendment 8, the MSR will likely begin releasing 30 million allowances per year starting in 2022. In total, we estimate that the MSR will release 305 Mt into the market by 2030. Without Amendment 8, the MSR is projected to release 150 Mt in comparison. The higher flow of supply from the reserve results in a more oversupplied market, but its overall impact on the market balance is

relatively minor according to our model. This is partially due to the relatively small volume of the allowances released due to Amendment 8. Another reason is the fact that this provision causes the market to engage in slightly less abatement, which counterbalances the amendment’s effect on the market balance to some extent. This is illustrated by our forecast of the accumulated market balance in 2030 without Amendment 8, which we estimate at 219 Mt, compared to 274 Mt with the amendment.

Figure 2 displays the results of our price forecasting model assuming Mr. Belet’s proposal. The carbon price is projected by our model to stay around €10/t until 2020. We expect the price to be higher than under the Commission’s proposal around 2020, as the 900 million backloaded allowances are no longer reintroduced to the market. From 2021, the effect of the MSR will likely become fully reflected in the carbon price. As of 2021, the price is projected to begin rising significantly as a result of the declining oversupply. Our model projects an average carbon price of 26 euros in the period 2021-2030 in real 2010 euro terms. This projection is two euro higher than the price under the Commission’s MSR proposal. For the time period between 2014 and 2020, our model predicts the carbon price to be one euro higher with Mr. Belet’s proposal compared to the Commission’s.

Figure 2: Carbon prices – comparison of ENVI and Commission proposals



As discussed above, Amendment 8 has a relatively small impact on the market balance. Our model estimates that this amendment results in a one euro lower average price in the 2021-2030 period than we would see without the amendment in place. However, we note that the amendment may have sentiment-driven impacts on the market, which we have not accounted for in our modeling. The amendment effectively creates a precedent for the use of MSR allowances for purposes other than the MSR’s stated objectives. This may be seen as a prelude to further amendments which empty the reserve

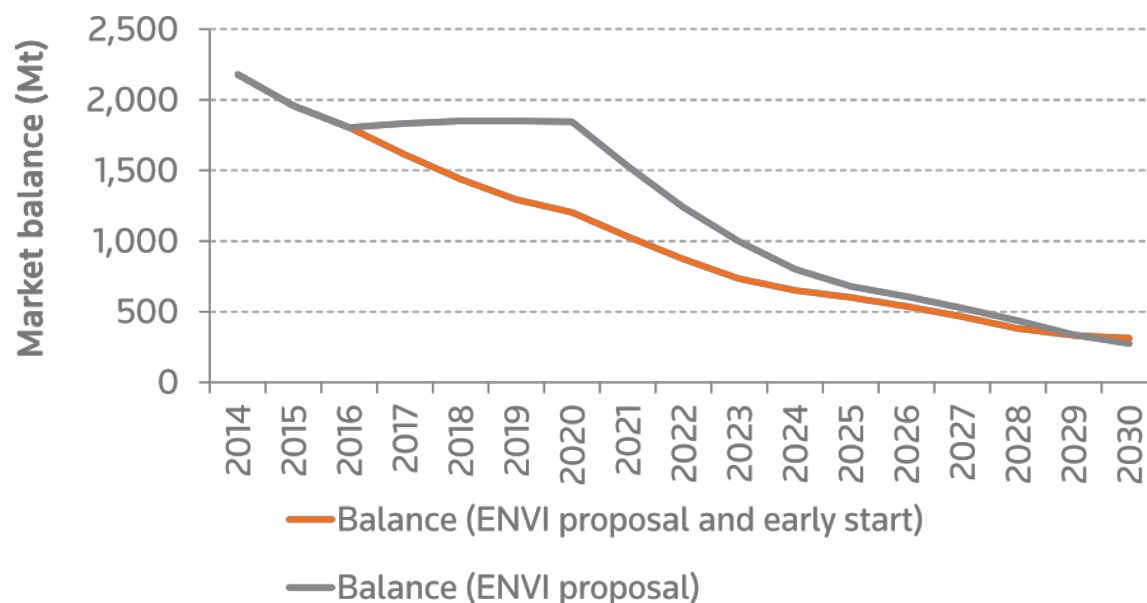
and result in additional increases in market supply. Such a precedent may be seen as a risk factor for the carbon price, and may keep the price lower than it would otherwise be.

Why the start date matters – triggering more abatement at a low cost

In his explanatory remarks to the draft ENVI report, Mr. Belet argues that the impact of the reserve would be limited even if it starts operating before 2021. Based on our modeling we find that the price impact of an early start would be limited while the impact on reducing emissions would be significant. In order to illustrate the effect of an early start date, we compare a scenario as proposed by Mr. Belet (start date in 2021, transfer of backloaded allowances and the provision for a yearly release of 30 million allowances from the reserve) to a scenario where in addition to the proposed amendments by Mr. Belet the MSR becomes operational already in 2017.

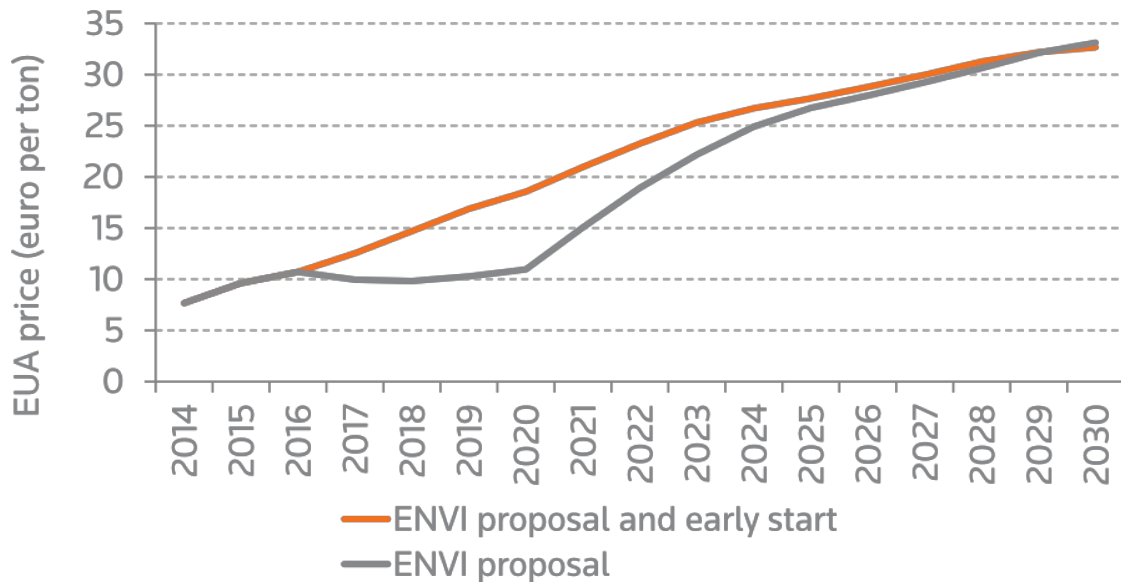
Figure 3 displays the effect of an early start date on the market balance, comparing it to Mr. Belet’s proposal of starting the mechanism in 2021. Opting to start the MSR in 2017, the surplus in the market would decrease immediately after the implementation. While in Mr. Belet’s proposal we see the surplus in the market at 1,845 million allowances in 2020, an early start date in 2017 would see the surplus decreasing to 1,204 million allowances in 2020 – a very significant difference. With an early start date, the reduction of the oversupply occurs gradually and relatively more slowly. This would make it easier for market participants to transition from the current period of high oversupply towards the likely shortage of allowances in the future. Emitters and other market participants will have a better ability to plan strategies for coping with future shortage of allowances and prepare for necessary emission reductions, which will lead to higher cost-effectiveness of the EU ETS.

Figure 3: Impact of an early start date on the market balance – steady reduction of oversupply if MSR starts early



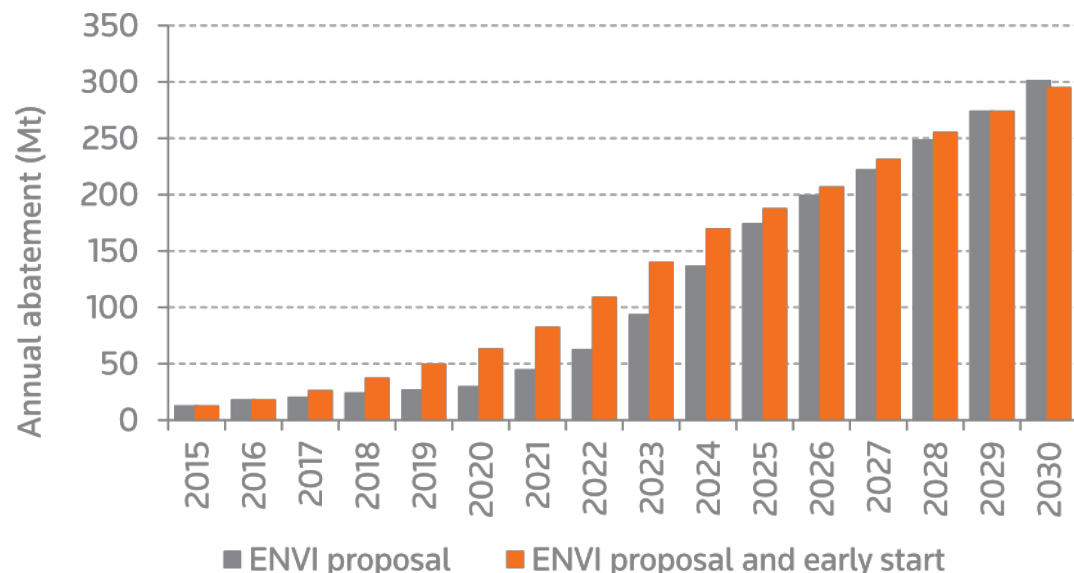
This is also reflected in the price trajectory, displayed by Figure 4. We forecast a slower and more stable price increase would result from an early start date. Overall, between 2014 and 2030, carbon prices would be €3/t higher with an early start date compared to Mr. Belet’s proposal. An early start date would result in a €3/t higher average price over 2014-2020 and a €2/t higher average price over 2021-2030.

Figure 4: Impact of an early start date on carbon prices – Three euro higher if MSR starts early



Having discussed the development of the carbon market balance and price trajectories, we find it important to evaluate the impact of Mr. Belet’s proposal on emission reductions. As displayed by Figure 5, the EU ETS under Mr. Belet’s proposal will reduce 1.9 billion tons of CO₂ between 2014 and 2030. If the MSR would start earlier (in 2017 in our example), 271 million tons could be abated in addition, mainly between 2017 and 2024. An early start date would incentivize more abatement occurring at an earlier point in time, hence facilitating the pathway to reach long-term emission reduction targets. A start in 2021, will in effect delay the reduction of these 271 million tons for after 2030, when the market will inevitably become short of allowances. Such a delay would mean that this abatement will require significantly more expensive abatement technologies. Starting the MSR in 2017 would reduce these emissions at a cost equal to a three euro average annual increase in the carbon price, as we have explained above. In comparison, reducing these emissions after 2030 would likely come with a significantly higher cost.

Figure 5: Impact of an early start date on emission abatement – 271 million tons more if MSR starts early



Next steps for the MSR file in Parliament

The debate on the MSR in Parliament will evolve rapidly over the next few weeks, with amendments to both rapporteur reports being proposed by MEPs by 24 November in ITRE and by 11 December in ENVI. This is followed by new debates taking place in the both committees on 3-4 December (ITRE) and on 21-22 January (ENVI). The votes finalising the committee positions are scheduled for 21 January (ITRE) and 23-24 February (ENVI). The lead committee, ENVI will take ITRE’s opinion into account by voting on it. In case of relatively similar opinions in the two committees, Mr. Belet will ask for a mandate to start trilogue negotiations with the Council to find a compromise acceptable to both institutions. If the views of the two committees are significantly diverging, he may ask the Parliament’s Plenary for such trilogue mandate, which may delay the start of the trilogue by a month or two.

Conclusions

Mr. Belet’s draft report for amending the MSR seems to strengthen the Commission’s proposal through the transfer of the backloaded allowances into the reserve while keeping an eye on industrial competitiveness. The provision to release 30 Mt per year from the reserve if more than 400 million allowances are collected could generate around 7.1 billion euros to be used for funding low-carbon technologies in the industry sector. This ear-marking could be another concession to industry sectors and a means to prevent carbon leakage.

Our model finds that an earlier start date than 2021 would trigger a significant amount of additional abatement until 2030 and prepare the market to contribute to long-term emission reduction targets at a moderate price increase. An early start date would reduce the oversupply from an earlier point in time,

leading to a more steady reduction pathway as well as a more steady price trajectory. Even though Mr. Belet did not suggest this in his initial report, he mentioned to personally not being against starting the operation of the MSR at an earlier point in time. We expect Parliamentarians in the Environment committee to file such amendments maintaining the discussion on the start date high on the agenda.