

UK's position on the European Commission's proposal to reform the EU ETS by introducing a Market Stability Reserve

20 October 2014

The UK supports the implementation of a strengthened MSR to:

- **improve the market mechanics of the EU ETS;**
- **ensure Europe can meet its GHG emissions reduction obligations more cost effectively;**
- **strengthen incentives for investment in low-carbon technologies; and**
- **protect industry against prices rising too quickly in the future.**

The current EU ETS design is flawed. Unlike supply in ordinary markets, the annual supply of allowances is unable to adjust to changing circumstances. As a result, the EU ETS has built up a significant surplus of allowances, undermining incentives for low-carbon investment and increasing the risk of higher costs in meeting long term emissions reduction targets.

By allowing the supply of allowances to adjust to changes in demand, as other ETS schemes do, a strictly rules-based reserve will improve the market mechanics of the EU ETS, substantially reduce the risk of future ad-hoc interventions such as backloading and minimise uncertainty for investors and businesses.

Without this, even under a tightened EU ETS cap in line with a 40% GHG emissions reduction target by 2030, the EU ETS surplus is likely to persist to 2030 and beyond, increasing the costs of meeting future targets.

As such, the UK supports the introduction of a MSR and calls for:

- **Implementation by 2017, to urgently address the surplus;**
- **Backloaded allowances to be cancelled and/or enhancement of the proposed mechanism to smooth auction volumes so that backloaded allowances are placed directly into the reserve. This will ensure sensible, stable development of auction volumes between phases; and**
- **Amendments to ensure allowances are retained in the reserve under 'business as usual circumstances' and therefore remain available to provide protection against insufficient liquidity and prices rising too quickly should these occur in the future.**

UK's continued support for the EU ETS

The UK supports a fully functioning and credible EU ETS as the most cost effective and economically efficient means to reduce our greenhouse gas emissions. The UK's vision for the future of the EU ETS¹ is for a System that:

- **Delivers EU emissions reductions consistent with meeting the long-term EU objective of reducing emissions by 80%-95% by 2050 at least cost (with an interim objective of 40% emissions reduction by 2030, moving to 50% in the event of an ambitious global deal), including by driving investment in the low carbon economy.**

¹ <https://www.gov.uk/government/publications/uk-vision-for-phase-iv-of-the-eu-ets>

- Strongly supports those energy-intensive industries that are at risk of carbon leakage² and helps to maintain their global competitiveness during the transition to a global low-carbon economy.
- Demonstrates global leadership through delivery of an effective and economically efficient emissions trading scheme, ready to link with all suitable ETS's as the foundation of a global carbon market.

In order to achieve these aims, strengthening of the EU ETS is required urgently. The UK has long called for reform of the EU ETS to ensure the carbon market remains on the cost effective emissions reduction pathway. We support the cancellation of an ambitious volume of allowances to achieve this. However, in the absence of support across the EU for this, as set out below, the UK supports introduction of a strengthened MSR.

Why does the EU ETS need reform?

The EU ETS market currently has a surplus of around 2 billion allowances³ which, if not tackled, is expected to depress the signal for low-carbon investment for at least a decade⁴ and is likely to increase the overall costs of meeting our future targets. Without reform, the credibility of emissions trading is being undermined risking a shift away from efficient, market-based emissions reduction to fragmented and regulation-centric approaches across the EU that could increase costs further and undermine the single energy market.

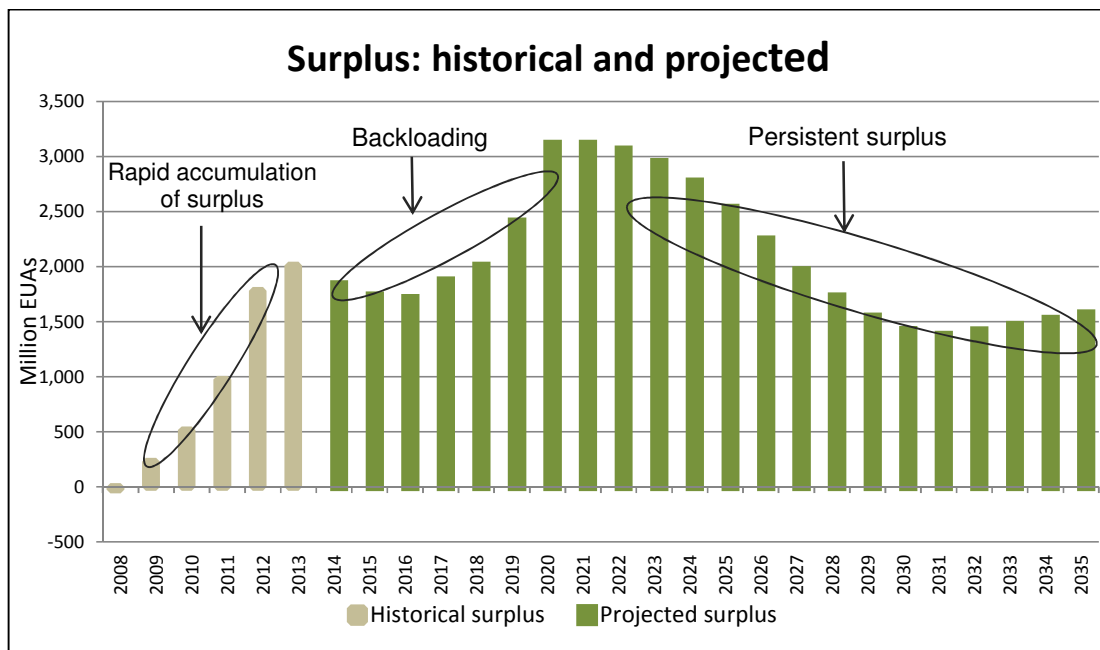


Figure 1: Number of allowances in circulation: historical and estimated surplus under a 40% GHG reduction target by 2030⁵

² Carbon leakage (definition from the Commission's website) is the term often used to describe the situation that may occur if, for reasons of costs related to climate policies, businesses were to transfer production to other countries which have laxer constraints on greenhouse gas emissions. This could lead to an increase in their total emissions. The risk of carbon leakage may be higher in certain energy-intensive industries.

³ Equivalent to a year's worth of allowances under the EU ETS cap.

⁴ DECC analysis shows even with a tightened cap in Phase IV to deliver a 40% GHG target in 2030, the surplus will reduce slowly and will remain significant in 2030. This is similar to results from Commission analysis: http://ec.europa.eu/clima/policies/ets/reform/docs/swd_2014_17_en.pdf Any further access to project credits within the cap will prolong the surplus.

⁵ Historical surplus from EUTL and projected surplus from DECC carbon price model 2014

The surplus is the result of a combination of factors, which include:

- An unanticipated shock - the economic recession;
- A weak 2020 target out of line with a least cost pathway to achieve 2050 emissions reduction goals; and
- Access to project credits within the EU ETS cap.

In January 2014, as part of their proposed policy framework for climate and energy to 2030⁶, the European Commission issued a legislative proposal for an MSR.⁷ The Commission also signalled an intention to tighten the EU ETS cap to meet a 40% domestic greenhouse gas target for the EU by 2030 and to continue protection for sectors at genuine risk of carbon leakage beyond 2020, but with a more focused approach.

UK's position on the MSR

The UK believes that an MSR could represent a positive reform if strengthened so that it urgently tackles the surplus, strengthens the low carbon investment signal and improves the resilience of the EU ETS to significant changes in circumstance in the future (such as a boom or recession).

An MSR will allow the EU ETS to operate more like an ordinary market (e.g. food and consumer products) by providing a mechanism for supply to respond to changes in demand. As such, the mechanism will reduce the risk that ad hoc interventions such as backloading will be needed in the future.

Other national and regional emissions trading schemes⁸ have recognised the shortcomings of a regulatory market that has a rigid supply and have been designed with mechanisms to provide some supply flexibility.

In principle, the UK supports introduction of an MSR because it:

- Is not an ad-hoc, arbitrary intervention, but a transparent, rules-based mechanism and as such predictable to the market;
- Offers protection to market participants against any future significant shortage of allowances by injecting allowances and thereby moderating carbon price increases;
- Will not impact on levels of free allocation for industrial sectors because the mechanism will only act to adjust the volume of allowances auctioned by Member States. Industrial sectors at significant risk of carbon leakage will be largely insulated from any increase in the carbon price resulting from the MSR, due to the current provision of free allocation and signalled continuation of these arrangements post-2020 as well as provisions allowing for compensation for the indirect (through electricity bills) costs; and
- Preserves the integrity of the EU ETS cap.

However, according to the UK's analysis, and that of some other market analysts, the Commission's proposal is unlikely to adequately correct the problem of oversupply in the EU ETS, and as such is insufficient to put the System on the right track once and for all.

Therefore, the UK calls for the proposed **MSR to be strengthened**.

Bring forward implementation to 2017: to adequately and urgently address the surplus. Even under the MSR proposed by the Commission we expect high surplus and accompanying inadequate investment signal to persist for a decade or more.

⁶ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52014DC0015:EN:NOT>

⁷ http://ec.europa.eu/clima/policies/ets/reform/docs/com_2014_20_en.pdf

⁸ Including Regional Greenhouse Gas Initiative (RGGI), California, Quebec and Australia

Address the return of backloaded allowances, either through cancellation and/or enhancement of the proposed mechanism to smooth auction volumes so that all the backloaded allowances are placed directly into the reserve. Even with the Commission’s proposed smoothing mechanism (Article 2(3)) a flood of allowances would first flow into and then out of the market from 2019 until the mid-2020s. These swings in supply across years could create fluctuating prices and as such increase uncertainty for industry and undermine investment incentives. The operation of the smoothing mechanism should be extended across 2019 and 2020 with excess allowances placed directly into the reserve. In addition to addressing backloaded allowances, this would have the added benefit of addressing another source of oversupply; as a potentially significant volume of unallocated allowances⁹ are due to be auctioned in 2020. An enhanced smoothing mechanism will therefore ensure a sensible and stable development of supply and prices over the coming decade. The UK supports cancellation of the backloaded allowances to provide a stronger investment signal that is more clearly in line with long term GHG goals.

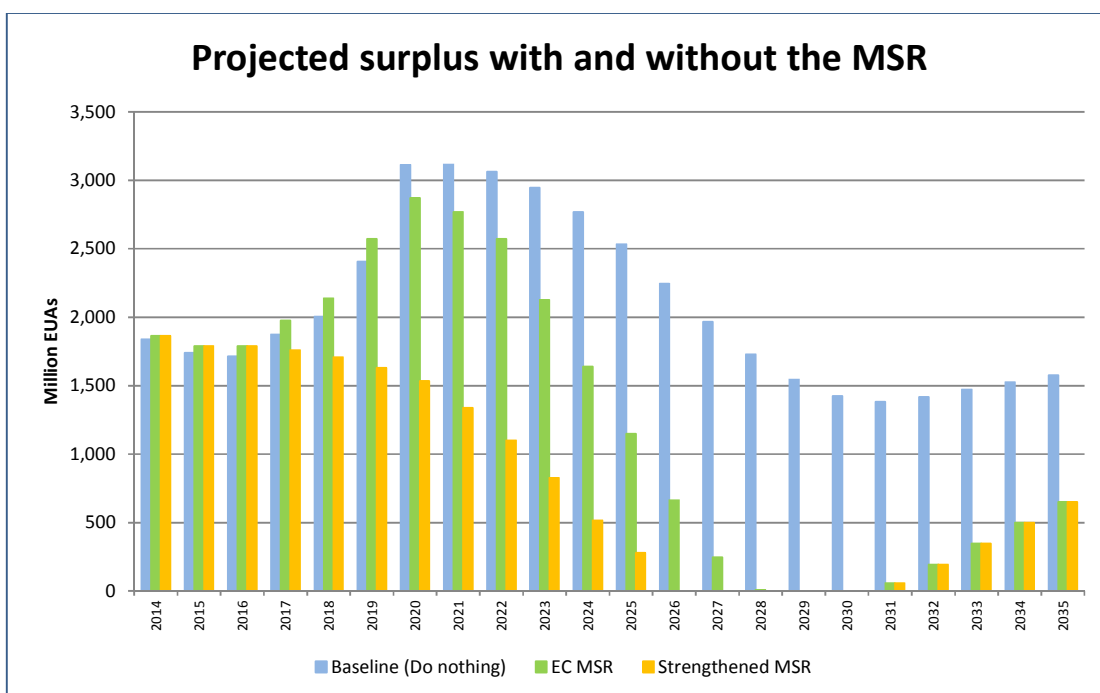


Figure 2: Impact on the surplus of EC MSR and strengthened MSR (implemented from 2017 with an enhanced smoothing mechanism to place backloaded allowances directly into the reserve).¹⁰

Secure investment incentives while protecting against future price shocks

For the reserve to work sustainably it is also crucial that allowances placed into the reserve return to the market only in the right circumstances. Investment incentives would be undermined and cost efficiency benefits lost if allowances are injected back into the market too quickly and merely as the scarcity intended by the declining cap is restored to the market. The threshold to return allowances should therefore be set in such a way that it will only be triggered when the market is under pressure, for example as a result of unforeseen, significant changes in demand, such as an economic boom. There remains a risk that the proposed threshold of 400m allowances could lead to allowances returning to the market

⁹ Unallocated allowances from, for example, the New Entrant Reserve and installation closures are due to be auctioned in 2020.

¹⁰ Modelling assumes that no surplus is used for hedging. If hedging is assumed then surplus will not reduce to zero.

soon after the reserve stops filling and in the absence of any outside shock. Therefore, UK believes that amendments are needed to either to reduce the surplus threshold below 400 million, or to return allowances only when both the price rise (Article 29a) and surplus thresholds are met simultaneously.

In addition, the UK supports **periodic review** (every 5 years) of the MSR settings, within a legislatively defined scope and criteria, in order to ensure those settings remain appropriate in an evolving carbon market whilst preserving certainty for the market.

Please contact the DECC EU ETS team at eu.ets@decc.gsi.gov.uk if you would like to comment on the UK's position on the MSR or contribute your views to further policy development on more detailed elements of the MSR.