



ETS Market Stability Reserve: Making it work like a normal market

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July, 2014

Change Partnership was established as an *association sans but lucratif* (ASBL) in 2013 to provide independent thought and organisation of political solutions to advance sustainable development and avert dangerous climate change.

Registration number: 0524.743.076

Intermediate structural reform: The Market Stability Reserve

The EU Emissions Trading System (EU ETS) was meant to be the key driver for European decarbonisation, a spur for low-carbon innovation and competitive advantage. Its failure to provide long-term direction and short-term investment has seen the EU rapidly fall behind key competitors, low-carbon investments shelved and an increased exposure to high-cost and high-carbon energy imports. For example, the EU planned to 'stimulate the construction and operation' of 12 carbon capture and storage (CCS) demonstration plants by 2015¹. To date only one CCS project has secured funding² whilst the US already has seven operational plants, Brazil and Algeria each have an operational plant and there are nine Chinese plants in the pipeline testing different sectorial applications³. The EU is also losing ground in other sectors such as renewable energy capacity where China invested \$56 billion in 2013 compared to only \$48 billion in the EU⁴ and innovation which witnessed a 10-year strategic partnership between the US and China to develop technological solutions of the future in areas such as modern electricity grids, electric cars and energy efficiency⁵.

Swift, decisive and correct response is required from the EU. Correcting the EU ETS is therefore, essential. However, full-scale reform is likely to be a lengthy process with little evidence that it will deliver the required results within an acceptable timeframe. Moreover, confidence in the importance of the EU ETS needs to be restored. The Market Stability Reserve (MSR), if designed correctly, becomes an essential vehicle to recapture lost ground. The MSR acts as an interim bridge sending two clear signals. Firstly, it should restore confidence in a robust carbon price investment signal. Secondly, it could deliver short-term results to governments and companies that have invested in low-carbon solutions, innovators and government revenues needed to support sustainable growth, innovation and employment.

Problems with the EU ETS

The EU ETS has had constant and severe structural imbalances between supply and demand of allowances over its nine year operational lifespan. The main immediate problems are:

- **External shocks:** The market is unable to respond to external shocks such as the economic crisis or breakthrough technology.

¹ European Commission 'Supporting early demonstration of sustainable power generation from fossil fuels'. COM(2008) 30 final

² European Commission press release IP/14/780 08/07/2014

³ Global CCS Institute, 'Status of CCS database'. Accessed 11 July 2014.

⁴ Bloomberg New Energy Finance, 'Global trends in renewable energy investment 2014', 2014.

⁵ US-China MOU to enhance cooperation on climate change, energy and environment, 28 July 2009

- **Investor confidence:** The weak carbon price caused a lack of investor confidence in new investment. It also undermined the financial rewards of low-carbon investments initially triggered by the carbon price signal.
- **Surplus:** In 2013 there were around 2 billion allowances more than needed for compliance depressing prices to €4. This surplus is estimated to increase to 2.6 billion by 2020.

Commission's proposal⁶

The Commission proposed the introduction of an MSR in response to these problems with 'the specific objective' to 'restore the functioning of the European carbon market in the short-term'.⁷ The key features of the proposal are:

- **Market surplus definition:** This is defined as



- **Rules-based functionality:** Automatic adjustments based on transparent rules, which are based on the market surplus definition, reduce political risk and send clear signals to market participants.
- **Thresholds:** An upper and lower quantity threshold are introduced to provide some stability to the market. In conjunction with the Market Surplus defined above:
 - **Upper threshold:** If there are **more than 833 million tonnes** in circulation then 12% of this surplus is placed in the Reserve.
 - **Lower threshold:** If there are **less than 400 million tonnes** in circulation then 100 million tonnes are withdrawn from the Reserve and placed into the pool for auctioning.
- **Responsiveness:** Changes to the market surplus are made two years after a surplus or lack of surplus is detected.
- **Start date:** The Reserve comes into effect from 2021. The Commission estimates that this will remove the surplus after 2030.

⁶ COM(2014) 20/2

⁷ European Commission, 'MSR impact assessment', 2014. SWD(2014) 17 final page 11

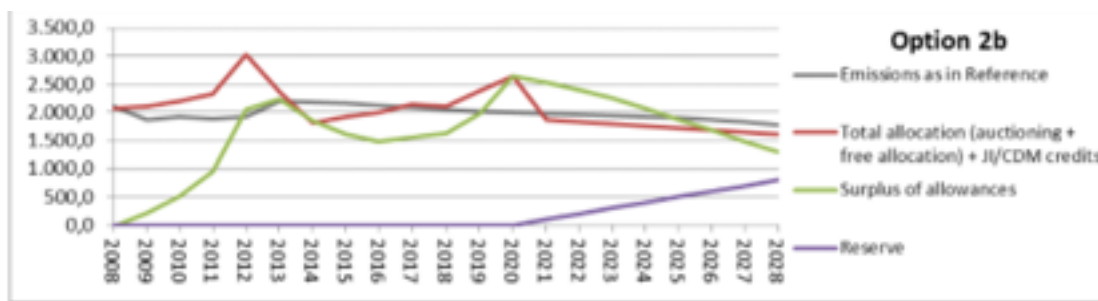
Analysis the Commission's proposal

The Commission has made a robust starting point which requires three critical changes to make the carbon market work. These are *speed, timing and the removal of investor uncertainty*.

Removal of investor uncertainty

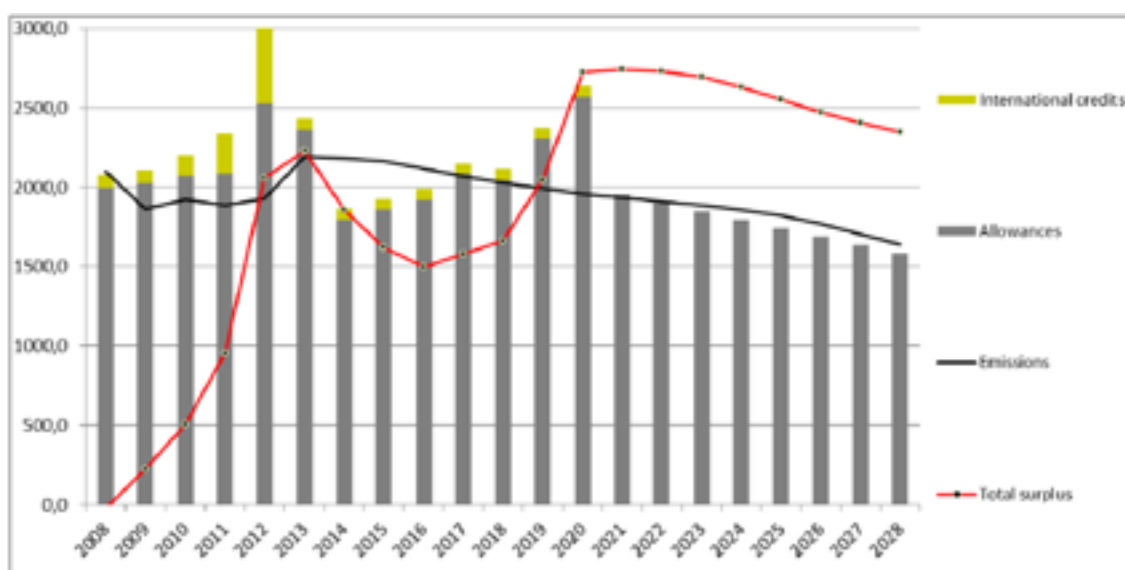
The Commission's own analysis indicates that the surplus will not be removed before 2030. Had the current MSR proposal been in place during the 2008-12 crisis it would have taken decade to remove the surplus as outlined in Figure 1. The surplus will continue to undermine confidence in the ETS. Therefore, either partial or permanent removal of the surplus is the key short-term priority.

Figure 1: Effectiveness of current MSR proposals⁸



The Commission is correct in recognising that the 2.2% linear reduction factor from 2020 will have little impact on the surplus which justifies introduction of the MSR as highlighted in Figure 2.

Figure 2: 2.2% linear reduction factor with 900 million backloaded allowances⁹



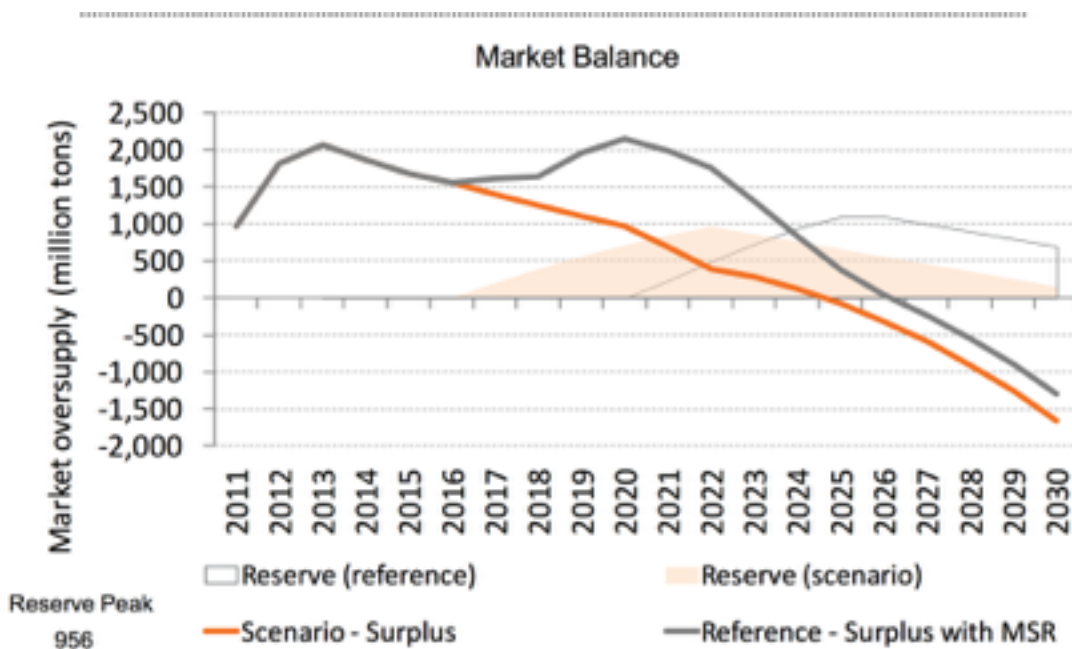
⁸ SWD(2014) 17 final page 36

⁹ SWD(2014) 17 final page 11

One option is to cancel the 900 million allowances that were backloaded. However, analysis from Point Carbon indicates that this only becomes effective in combination with a 2017 start date for the Reserve. This should deliver market balance by 2025 as outlined in Figure 3. Another way of addressing the issue would be to move the 900 million allowances directly into the Reserve in 2017. This would have the same market balance implications outlined below. The effect of this would be to create a bloated Reserve. *There is no evidence from large-scale investors whether a 'fat' Reserve in which all allowances eventually return to market would trigger significant investment. This is a key question which must be answered during the policy debate.*

Another option is to either remove the surplus in fixed instalments as used in the backloading directive. For example, XX million allowances could be removed in one or many years until market balance is reached. The preferred option is to introduce a 'haircut' to the Reserve so that surplus allowances can be used to finance technological innovation, the 'Just Transition' to support high-carbon workers and regional restructuring. An upper limit of, for example, 500 million allowances is set for the Reserve. Allowances that come in on top of this are placed in a separate fund to support workers, innovation and regions. In the case of the transfer of 900 million backloaded allowances, 500 would go to the Reserve and the remaining 400 million directly into the new fund which would be topped up annually as the surplus is removed from market.

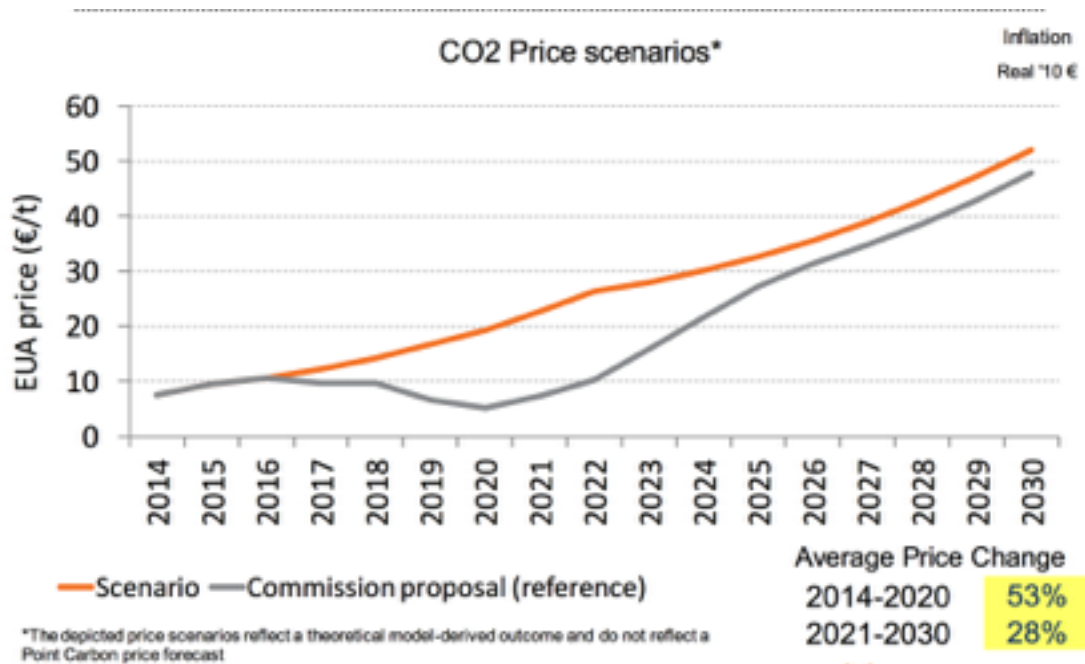
Figure 3: Cancellation of 900 million allowances and 2017 start¹⁰



Importantly, Figure 4 indicates that the scenarios described above does not lead to a carbon price greater than the carbon leakage €30 threshold before 2020. So it restores the investment and innovation signals as well as keeping within the confines of current carbon leakage provisions.

¹⁰ Point Carbon, 'MSR and impact on prices' | April 2014

Figure 4 Price impact of cancellation and 2017 start¹¹



Speed

The timing of the triggers also does not follow normal market movement. Allowances enter and exit the Reserve, in the current proposal, two years after a change in demand. No justification for this artificial rigidity is provided. Demand is indicated annually with publication of verified emission data in May. The impact of adjusting the Auctioning Calendar for the following year shortly after publication of verified emission data would be to send the most up to date price and investment signal to participants. Speed is important because companies assess the benefit of their investments on an annual basis. Failure to communicate the price annually is likely to undermine the Rate of Return and Net Present Value of these investments, an unnecessary and unhelpful outcome.

Timing

The most important aspect of the reform is timing. The earlier the ETS starts to work is crucial. Climate policy is not about delivering the right investment. If the EU ETS is to remain in chains it, and most likely EU action, will have little relevance. Many governments are introducing vastly different measures to stimulate low-carbon investment. Without a strong ETS, they significantly undermine the effective of the EU internal market as well as the fundamental purpose of the European Union. After all, if the EU cannot protect its citizens from the most destabilising extensional threat what purpose does it serve? Johannes Teyssen, CEO of E.On and current President of Eurelectric stated correctly that “It’s time not just to talk about new targets for 2020 and beyond, it’s time to fix the world today”.¹² Chinese officials share the same sense of urgency. Officials managing the Shenzhen ETS pilot in China confirmed that

¹¹ Ibid.

¹² Bloomberg, 'EON's Teyssen Urges Fix to 'Bust' EU CO2 Plan' (2012).

they would cancel 3 million surplus allowances at the end of the 2014, less than 150 days after it was launched, to avoid depressed prices and missing out on investments to be triggered by their ETS pilot scheme.¹³ If the ETS is to survive, the MSR proposal needs to be completed by early 2015 to allow maximum debating time for the 2030 framework and identification of the key policy to drive low-carbon investment.

Key improvements needed to the Commission's proposal

In light of this, the key amendments needed to make the market work are:

- **Earlier start:** The Reserve should be introduced in 2017 to smooth out the transition towards a balanced market and the price drop as 900 million allowances come back into the market.
- **Removal rate:** The 12% removal rate only makes marginal removals of the surplus. A 30% removal rate would ensure that the market returns to a normal, healthy balance before 2025 and therefore can drive investment as well as raise urgently needed finance for technology innovation and deployment.
- **Quicker response time:** Allowances released into and out of the market from the Reserve occur two years after the event. This is too slow. Allowances should come into or exit from the reserve the year after the verified emissions are published. The Auction Calendar for the follow year should be amended automatically after publication of verified emission data.
- **Review:** A review is scheduled for 2026. There is considerable uncertainty over the impact of the hedging trends as well as the effectiveness of the 400-833 million tonnes thresholds. Greater uncertainty would be caused by constantly revising these thresholds therefore, we recommend upholding the Commission's original proposal in this instance.
- **900 million backloaded allowances:** These should be placed directly into the Reserve to avoid a collapse in price towards 2020 which would undermine the effectiveness of the current MSR proposals ability to restore normal market operation.
- **'Fat' Reserve:** There is a concern among investors about the destabilising effects of a very large Reserve especially if all allowances will return to the market. Therefore, an upper limit or 'haircut' should be introduced to cap the size of the Reserve so that no more than x million allowances can be held. Allowances over this threshold should be automatically transferred into a fund to support technological innovation, worker skills and regional transformation or cancelled or a mixture of both.

¹³ Reuters, "China's Shenzhen to cancel surplus carbon permits" (23 April 2014).