EU ETS MARKET STABILITY RESERVE

POSITION PAPER

1. Foreword

The Shift Project is initiating an "EU ETS Working Group" starting with this position paper on the Market Stability Reserve (MSR) and will issue another position paper on the wider scope of EU ETS reform.

The Shift Project supports the objective of an appropriate price signal on carbon worldwide and in the EU. Under certain conditions, we also support linking carbon pricing mechanisms.

The Shift Project especially supports the European Union Member States efforts toward building a common, shared and **efficient** climate leadership. As EU leaders highlighted in the conclusions to the summit of 23 October 2014, the EU needs a "well-functioning, reformed EU ETS framework with an instrument to stabilize the market".

As per recital (8) of the Revised ETS Directive, **we support reinforcing the carbon price signal** necessary to:

- **Trigger the investments required to achieve the long-term target** [1]
- Create new abatement opportunities,
- Enhance the EU ETS predictability,
- Avoid distortions in the internal market and
- Facilitate the creation of links between emissions trading systems.

To provide an appropriate CO2 price signal, we support the idea behind a rule-based "Market Stability Reserve" to rebalance the supply and demand of allowances in the market. We also support the proposed revision of the linear reduction factor.

[1] To achieve 80-95% GHG reduction by 2050 as compared to 1990 levels.

2. Key Messages

To improve the EU Commission's proposal, our key recommendations are the following:

1. **Implement the MSR as soon as possible**
2. **Directly place the backloaded allowances in the reserve**
3. **Add the possibility of placing allowances within the MSR if prices fall too rapidly**
4. **Environmental integrity of the EU ETS in the long term requires reinforcing the level of cautiousness before any release of allowances**
5. **Implement periodic reviews of the MSR functioning and parameters would help to keep it simple appropriate to changing and unpredictable situations.**
6. **Make the MSR more responsive to balance changes by reducing the time-lag between the assessment of allowances in circulation and the withdrawal of allowances from the market**

3. Implement the MSR as early as possible

On the one hand, the European Commission estimates that the surplus has been an issue for years and should be absorbed by the MSR. On the other hand, the MSR is slated to start in 2021 only (6 years from now) meaning that the EU ETS will keep on creating unabsorbed surplus and that the existing surplus will persist until the end of phase 3.

Starting the MSR in 2017 avoid increasing the surplus of allowances and create much sooner an incentive to make important low-carbon investments.

- **We recommend the implementation of the MSR as soon as possible and no later than 2017.**

4. Place all backloaded allowances in the MSR

Backloading will bring back an amount of 300 MT in 2019 and 600 MT in 2020 to the market. European Commission (EC) proposal in its article 1.3 establishes a rate of 12% of allowances in circulation to be placed in the reserve. Absorbing 90% of the backloaded allowances would take 19 years of MSR place-in. We believe that reintroducing backloaded quotas back in the market at the end of Phase III would create a new downward "shock" for the market and could translate into a significant price drop.

- **We recommend the direct place-in of the 900 MT of backloaded allowances into the MSR.**

5. Add the possibility of placing allowances within the MSR if prices fall too rapidly

EC proposal art. 1.5 states that the MSR would release general allowances if Art29a of the revised ETS Directive is activated.

The Article29a is the only price-based action-lever in the revised ETS Directive and in the EC proposal for a Market Stability Reserve.
Subsequently, "***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 provision will be activated and may lead to anticipated auctions and increased auctions volumes.

The MSR should not only protect the market against the price signal rising too rapidly, as does the EC proposal, **but also against the price signal falling down too rapidly which is part of the objectives of the MSR and of the EU ETS reform**.

EC proposal for the MSR includes price-triggered events. The text currently protects the market only against prices raising too fast i.e. against the possibility for low-carbon investors to earn money too rapidly.

Our suggestion aims at rebalancing this design, protecting the market against prices falling down too rapidly i.e. against the risk for low-carbon investors to incur losses too rapidly.

- **We recommend protecting the market against prices falling too rapidly, in consistency with existing measures protecting the market against prices rising too fast**

6. Prevent adverse effects of the MSR releasing allowances in the market

The MSR is cap-neutral but will nevertheless alter the cap profile, as did the backloading. Indeed, in the short-term, the MSR will lower the initial cap (increase scarcity), while, in the long term, the release of allowances from the MSR will reduce scarcity of allowances.

As a consequence, while the MSR will *presumably* trigger low carbon investments, the MSR also *means that scarcity* of allowances will be reduced in the long term.

Sending a signal to the market, that long term caps (e.g. 2050) will be less stringent, would have a negative impact on the credibility of the long term ambition and could induce a less efficient price signal for emissions. It could also let the cap be perceived as an entitlement to emit GHG, instead of a safeguard which shall in no case be overridden.

In addition, the amount of 100 MT to be released seems quite low now, as compared to annual allocations (approx. 2 GT). In the long term, this amount will represent a significant share of annual allocations, and due to free allocations, will represent an even more significant share of annual auctions.

The MSR will rapidly hold extremely significant amounts of allowances. Since the release of these allowances could have severe adverse effects, and since neither market supply nor demand conditions can be forecasted in a reliable manner:

- **We especially recommend that the amount of allowances to be released once the lower threshold is reached should be one of the key parameters reviewed within the framework of the planned review of this regulation.**
- **In the event that conditions are met to release allowances in the market, the amount to be released should be determined in a way that the amount of yearly auctions would not be significantly increased**

We recommend strengthening the conditions under which allowances would be released. Would it make sense to release allowances in the market if prices are low to very low?

Raising the level of cautiousness preceding any release of allowances would reinforce credibility of long term climate goals and would also reinforce certainty regarding future scarcity of allowances. Indeed, the release-event would move from “certain” to “possible under certain conditions”.

- **We recommend that the emphasis on certainty provided by the MSR should shift from “future release of allowances” to “future scarcity of allowances”.**

This would also make it clear for economic agents and investors that long term climate goals will not be made easier by the ongoing reforms of the EU ETS.

7. Implement periodic reviews of the MSR

As we know from phase 2, neither market conditions, nor economic circumstances, nor emissions profiles can be forecasted in a reliable manner**.** In line with an earlier implementation, the first review year should be no later than 5 years after the first allowances have been placed in the reserve.

- **We recommend that MSR functioning parameters should be periodically reviewed.**

8. Reduce MSR time-lag

The MSR time-lag should be reduced, making the MSR more dynamic and more responsive to market changes. One year instead of two is already feasible.

- **We recommend reducing the MSR time lag**

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The Shift Project is a think-tank centred on the transition to a fossil-free economy. It seeks to guide the decision-making processes of companies and public institutions by bringing forward innovative proposals built on scientific facts *(www.theshiftproject.org).*