

French non paper on MSR proposal



Cécile Goubet

**General directorate of energy
and climate**

Carbon market department

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Agenda

- I. Background
- II. French first views
- III. French work on MSR proposal
- IV. Recommendations from the non paper
- V. Modelling results

I. Background

The carbon price is too low to trigger investments required to achieve the long-term targets

causes

Lack of credibility

Expectations of market players on the level of carbon constraint in the long-term are insufficient.

necessitates

- New 2030 ETS target (in accordance with global 2030 EU climate goal) necessary to give visibility to industrials.
- Establishment of a 2030 framework that prevents/limits overlapping with other policies

Rigidity of supply

The market can not accommodate an exogenous shock or interaction with other policies.

necessitates

- ### Need for a structural reform
- To reduce the current surplus to send faster a price signal credible & conducive, consistent with the 2050 goal and sustained over time.
 - To allow a market adjustment to neutralize the interactions with other policies or face unanticipated demand shocks.

Surplus allowances

The oversupply greatly reduces the constraint in the short term and will not be absorbed before 17 years(Thomson Reuters analysis).

necessitates

II. French first views

- Support the establishment of a mechanism allowing the European carbon market to be more stable, more efficient while remaining predictable.
- Support quantity based mechanisms
- Welcome the MSR proposal as a good basis

III. French work on MSR proposal

- Ministry of Ecology and Ministry of Finance mandated two inspection bodies to deliver a report in order to prepare the French position.
- Between December 2013 and February 2014, an extensive work has been done:
 - Literature review
 - 110 stakeholders met
 - Modelling work conducted by the French authorities made using Zephyr model developed by the Climate Economics Chair
- French authorities conclusion is to recommend an adaptation of the MSR:
 - Thresholds
 - Parameter to fill and empty the reserve
 - Time lag in MSR reactions
 - Review of the MSR
 - Governance

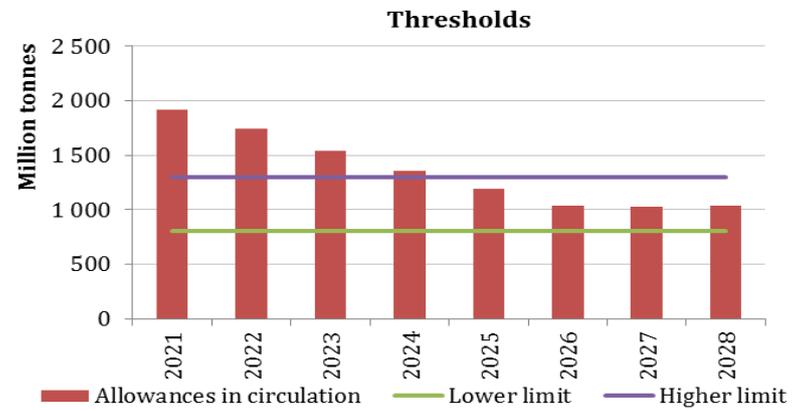
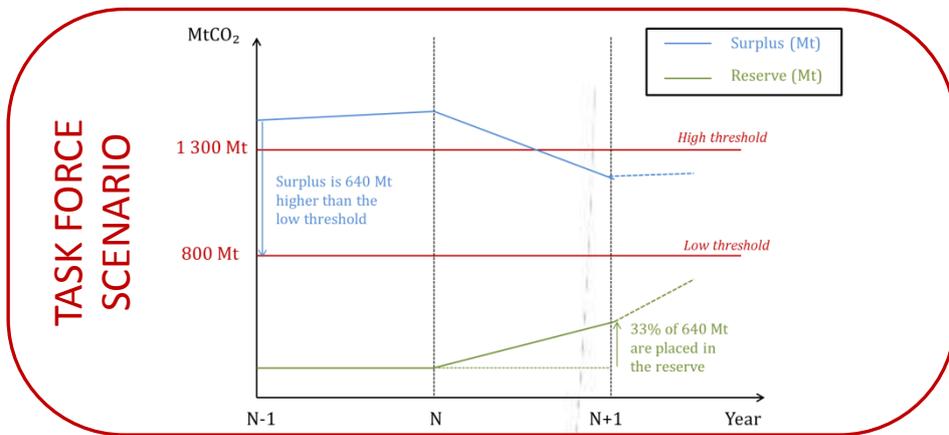
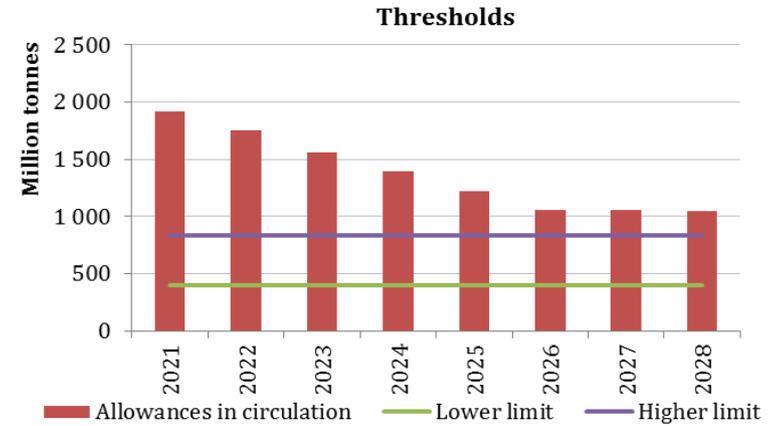
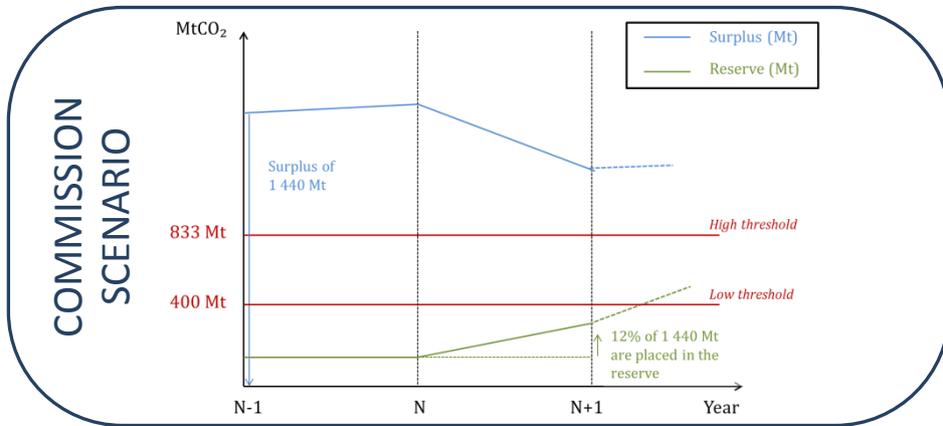
IV. Recommendations from the non paper

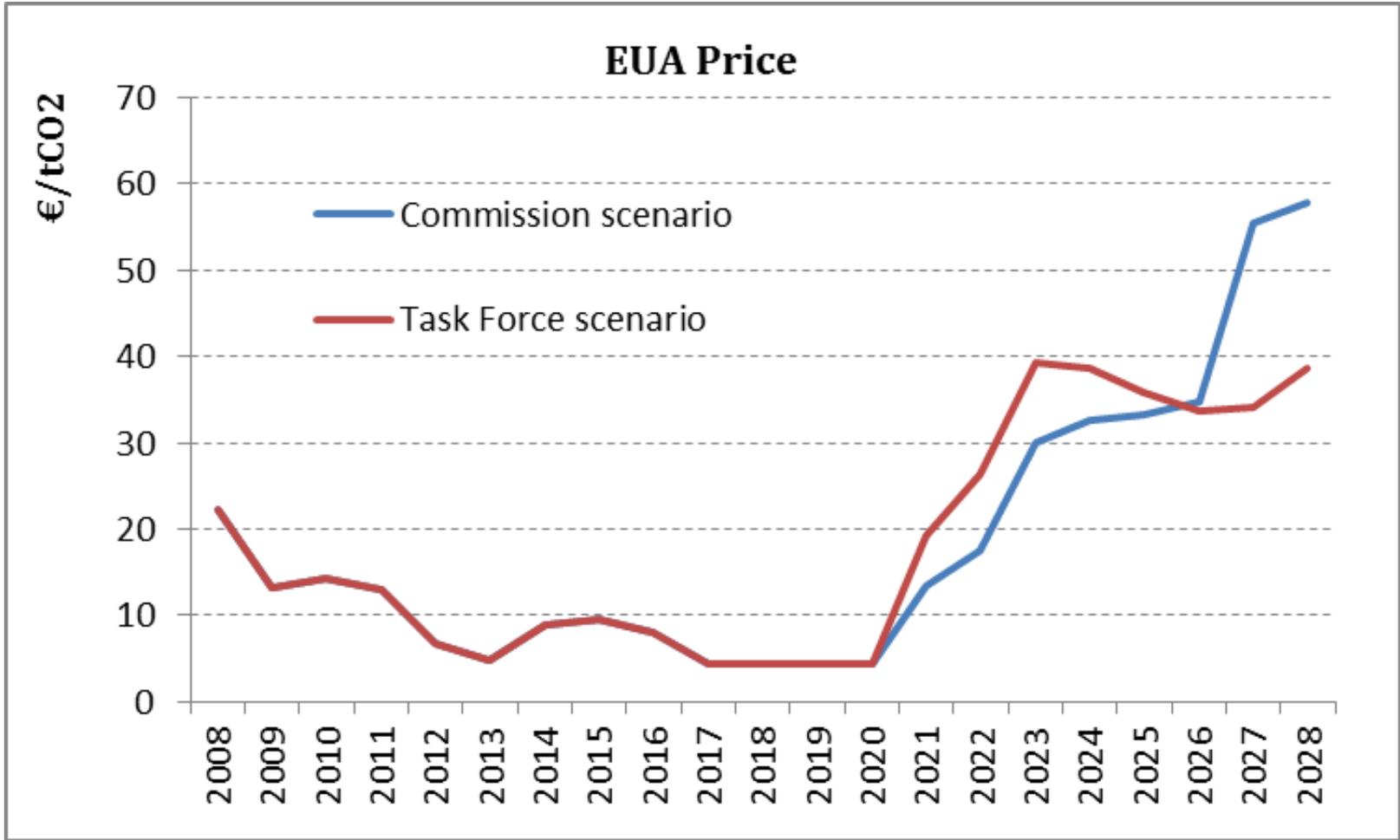
- **Higher thresholds to ensure hedging needs of market players: 800 MtCO₂ and 1 300 MtCO₂**
 - To adapt more easily to the needs of covered entities;
 - To prevent too much pressure being imposed on the demand side and consequently on carbon prices in phase IV (especially if economic growth is higher than expected)
- **Symmetric approach to fill and empty the reserve**
 - filling the reserve with yearly amounts equal to 33% of the difference between the surplus and the lower threshold, and symmetrically, empty the reserve with yearly amounts equal to 33% of the difference between the higher threshold and the surplus.
- **Reduce the time lag in reaction of the MSR to the year after the emissions have occurred**
- **A better linkage between backloaded allowances and the MSR should be considered in more detail**

IV. Recommendations from the non paper

- **Review of the market stability reserve mechanism**
 - CO2 Market drivers may change rapidly and in an unexpected way ;
 - The market as we saw it today may be different from the one we will face in 2021;
 - Letting the door open to a more frequent review may help to closely assess the evolution of the carbon market.
- **Governance: better assessment of the EU ETS**
 - The EU ETS is not isolated
 - Strengthen the technical and institutional capacity in order to
 - be able to assess and monitor the impacts of the mechanism on the carbon market.
 - to identify possible interferences between the mechanism and other energy or environmental issues, financial markets
 - to check consistency between all economic instruments.
 - A committee of experts could be responsible for delivering assessments and recommendations annually or every two years through a public report to the European Commission, the European Parliament and the Council

V. Modelling results





Thanks for your attention!



Annex: Zephyr Model

- Zephyr is a simulation model of supply-demand equilibrium in the EU ETS from 2005 to 2030:
 - Operators (sectors) are represented:
 - they have baseline emissions, driven by growth;
 - they receive free allocations;
 - they have marginal abatement cost curves.
 - Operators reduce emissions as long as their marginal abatement cost is below the market price.
 - Operators have expectations about the future and can bank surplus allowances:
 - they look at how much EUAs they will need over a certain anticipation horizon;
 - they can keep unused EUAs or buy EUAs to bank them for a later use;
 - intensity of banking is exogenous, so that different anticipation scenarios can be simulated; the Task Force decided to set the hedging demand at 1,100 Mt.
 - Each year the price starts at zero and rises until we reach a EUA supply-demand equilibrium on the market.
- Main assumptions of the scenarios
 - Allowance cap: -21% in 2020 / 2005; -43% in 2030 / 2005 from 2021 on;
 - Backloading on 2014-16 and 2019-22 (300, 350, 250 then 300, 200, 200, 200);
 - GDP: 1.5%/yr until 2020, 1.6%/yr afterwards;
 - Kyoto offsets after 2013: ~ potential use on 2013-2020 (600 Mt); 0 Mt after 2020.

Hedging assumptions

- Regarding banking behaviour of market players, intensity of banking is exogenous, so that different anticipation scenarios can be simulated. Assumption for French authorities modelling is that beginning phase IV, market players use allowances banked for compliance or for selling them (*debanking*), but that banking need cannot go under 1,1 GtCO₂
- DIW “Banking of emissions allowances – does the volume matter?” 2012 : The analysis suggests a potential hedging demand of 0.5 to 1.8 billion allowances in 2012.
DIW, “The Role of Hedging in Carbon Markets”, 2013 : This can result in adjustments to the CO₂ hedging demand between 1.1 to 1.6 billion t for discounting of future prices at 0 to 10%
- Bloomberg New Energy Finance (BNEF) predicts that of the 2.4Gt surplus in the system at end-2013, 1.3Gt is held by utilities for hedging purposes, 0.5Gt by industrials as a result of overallocation and the remaining 0.6Gt purchased by market participants for strategic purposes”.
- Eurelectric (2009): Eurelectric believes this is a conservative estimate and that as the EU market liberalises, more companies will adopt hedging policies, increasing the volume of allowances required to as much as 1100 million tonnes in each year.