

EU ETS Reform: Is Delegation the Key?

May 14, 2014

CEPS Task Force: EU ETS Market Stability Reserve

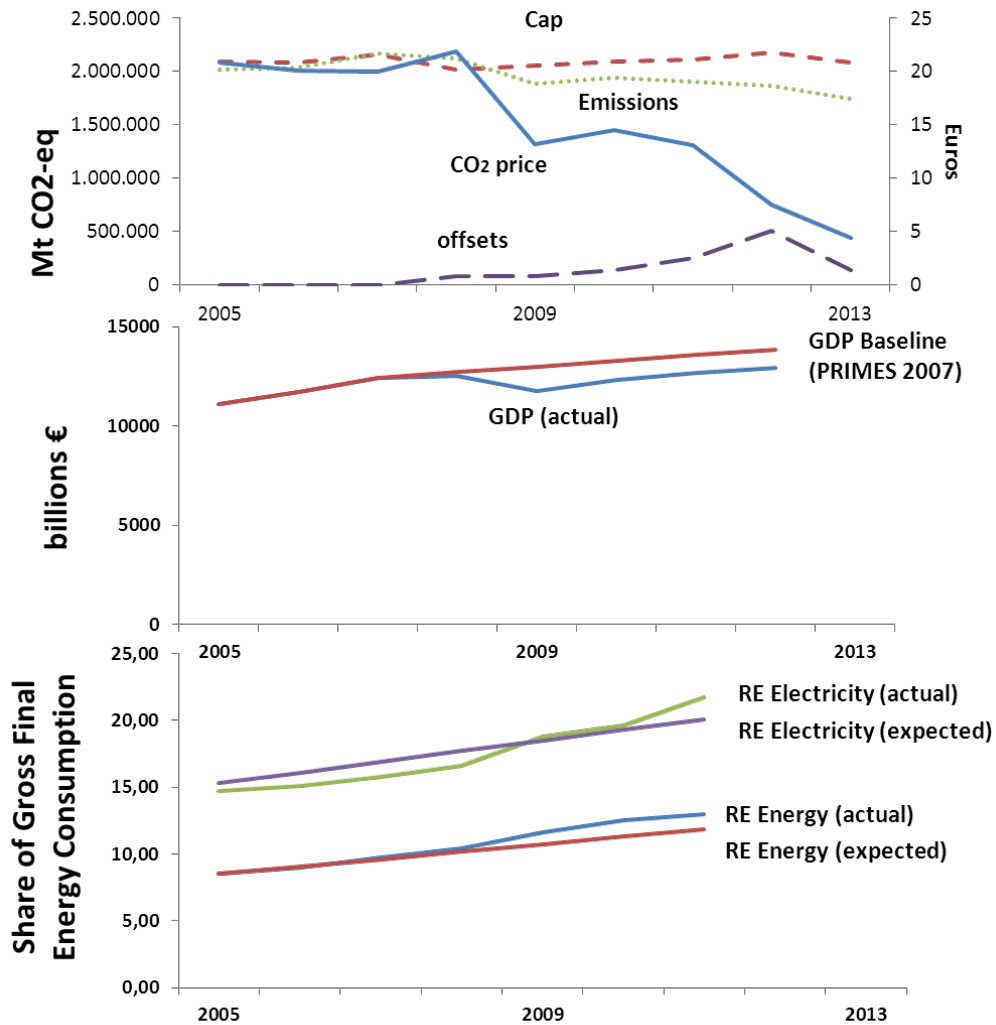
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Agenda

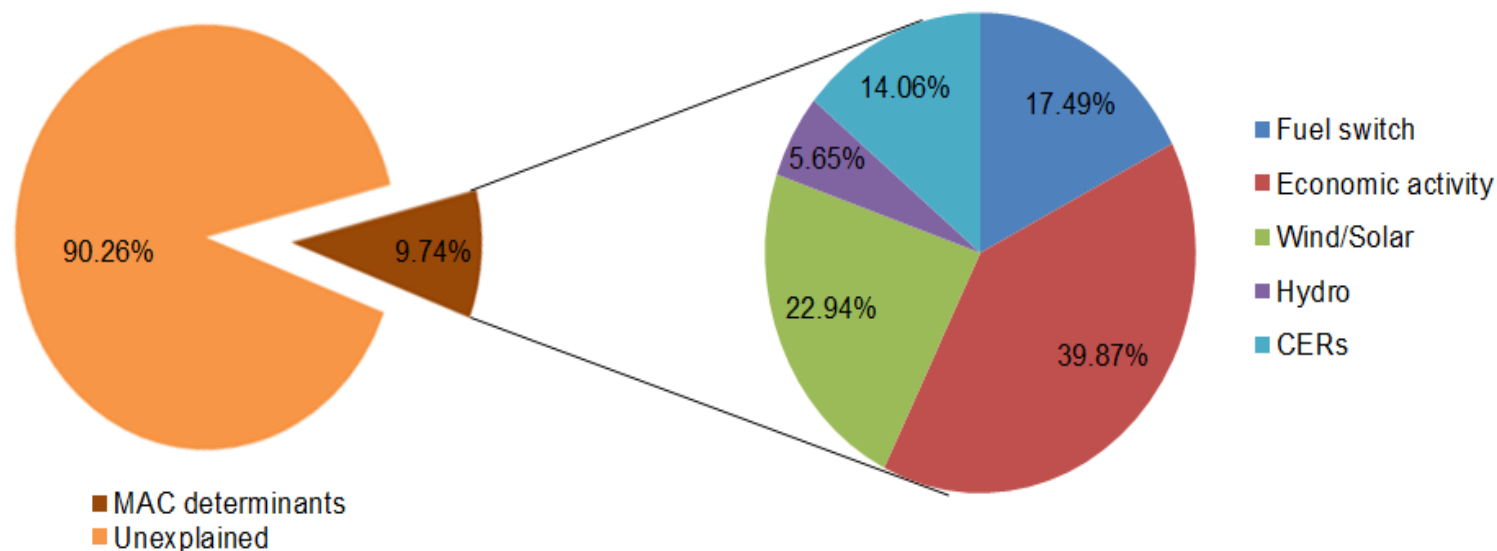
- **What happened to the EU ETS price? Empirical evidence**
- **Is the low price a problem?**
- **Should the EU ETS be reformed and if so – how?**
 - **What role can delegation play?**
- **The Market Stability Reserve**

What happened to the price?



Source: Grosjean et al. (2014)

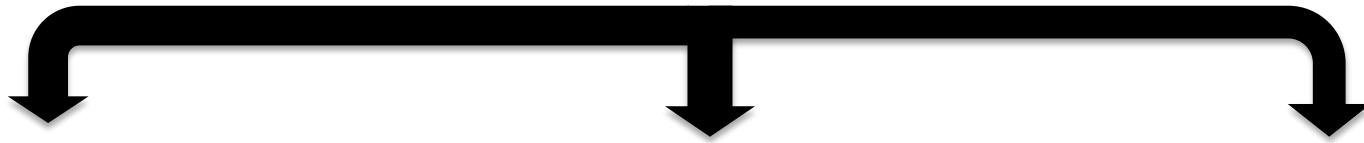
What happened to the price? Empirical evidence



Source: Koch et al. (2014)

BUT when taking into consideration policy events dummies (e.g. backloading vote), explanatory power jumps from 10% to 44%.

What are the reasons for the EU ETS low price and does it require intervention?



Exogenous Shocks

- Financial crisis and recession
- Policy Overlap
- Large import of CDM credits (at the end of phase II)

Intervention:

No if single objective:

- Short-term cost-effectiveness

Yes if multiple objectives

- Technological development (dynamic efficiency)
- EU leadership
- Internalize social cost of CO₂

Lack of credibility

- Uncertainty surrounding mid-term and long-term climate objectives
- Time inconsistency
- Lack of international agreement

Intervention: Yes

- Structural and institutional intervention to reduce (partially) uncertainty and enhance credibility.

Market Imperfections

- Excessive discount rate
- Asymmetric information

Intervention: Yes

- Market imperfections might justify some form of intervention. However, the specific type of intervention depends on the market failure.

Quantity
certainty

Price
certainty



Quantity
certainty

Price
certainty

Status
Quo

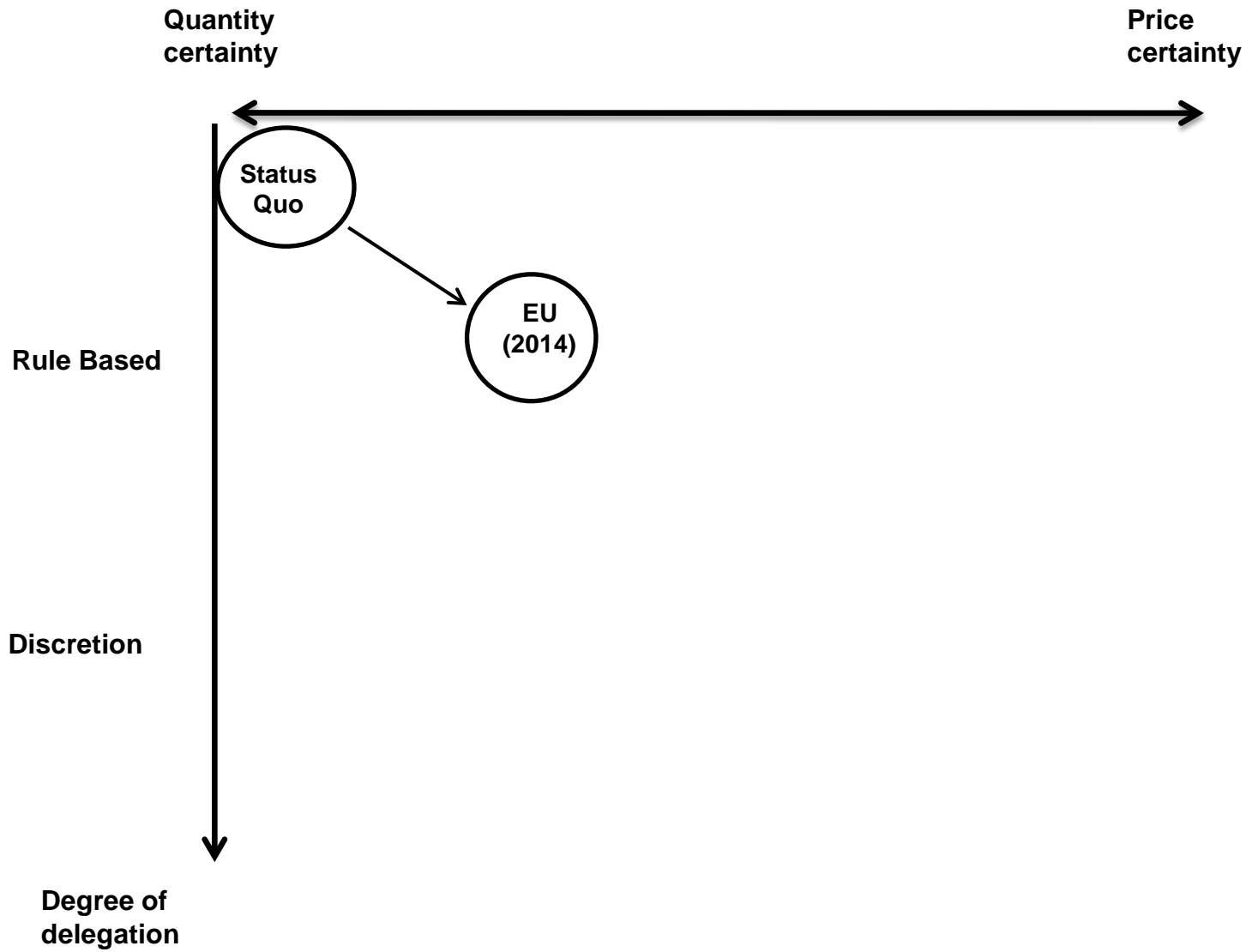
Rule Based

Discretion

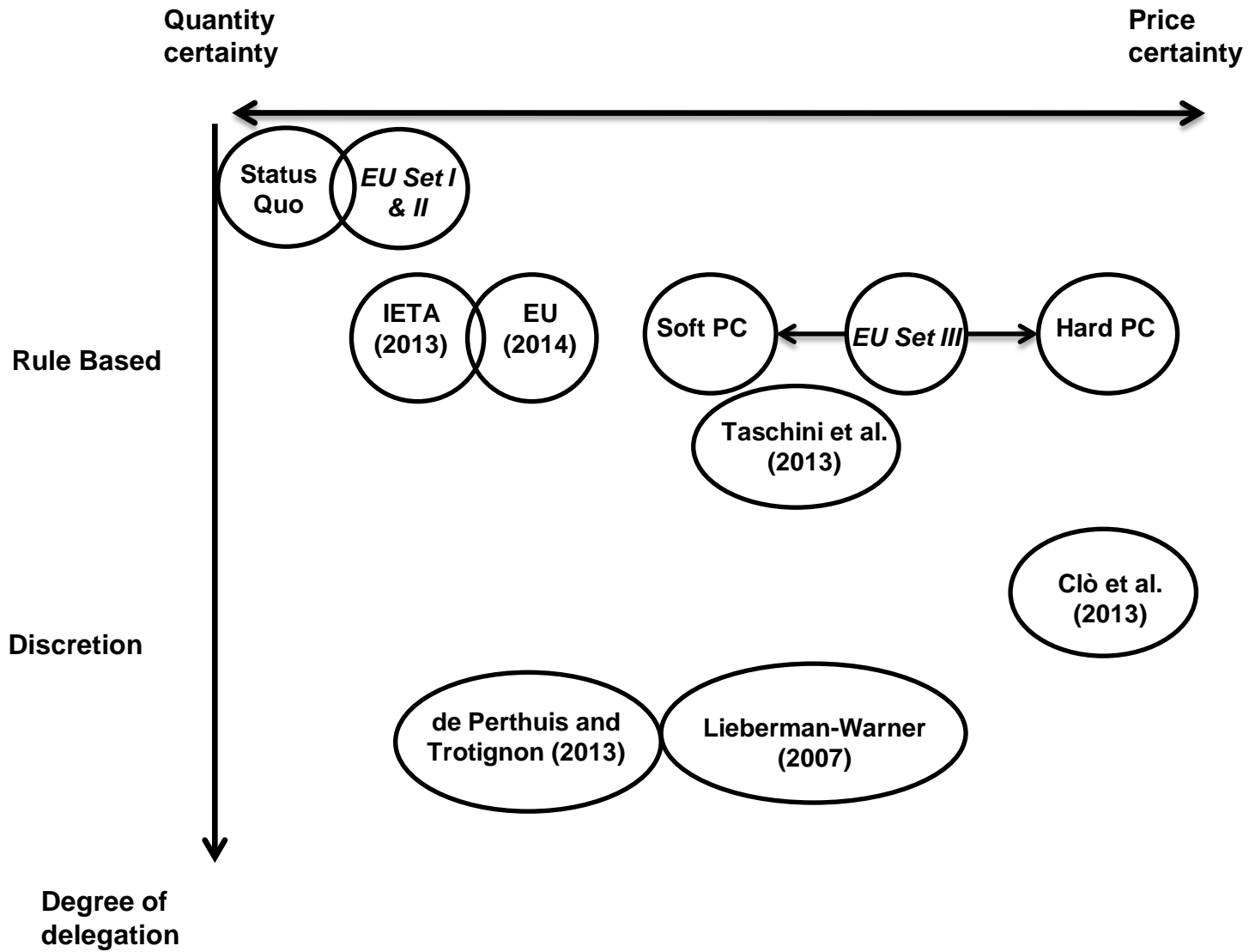
Degree of
delegation



Source: Grosjean et al. (2014)



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Source: Grosjean et al. (2014)

Quantity certainty

Price certainty

Exogenous shock (single goal)

Exogenous shock (multiple goals)

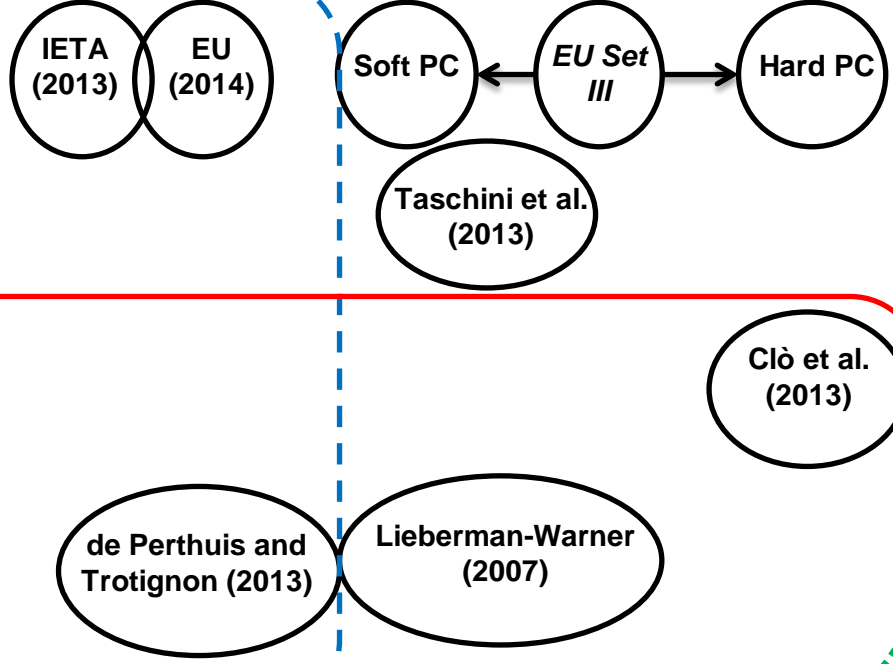
Status Quo

Rule Based

Market imperfection (hedging demand)

Discretion

Degree of delegation



Source: Grosjean et al. (2014)



Commission proposal (Market Stability Reserve)

- **Stated objective of EU ETS: long-term (dynamic) cost-effectiveness**

- **Concerns**
 - **„Market imbalances“ and – apparently - the corresponding low price prevent long-term cost-effectiveness (innovation & lock-in)**

The Market Stability Reserve

Feeding the reserve:

- When surplus > 833 million EUAs (y-1)
 - 12% of the surplus reduced from the following annual cap (y+1)

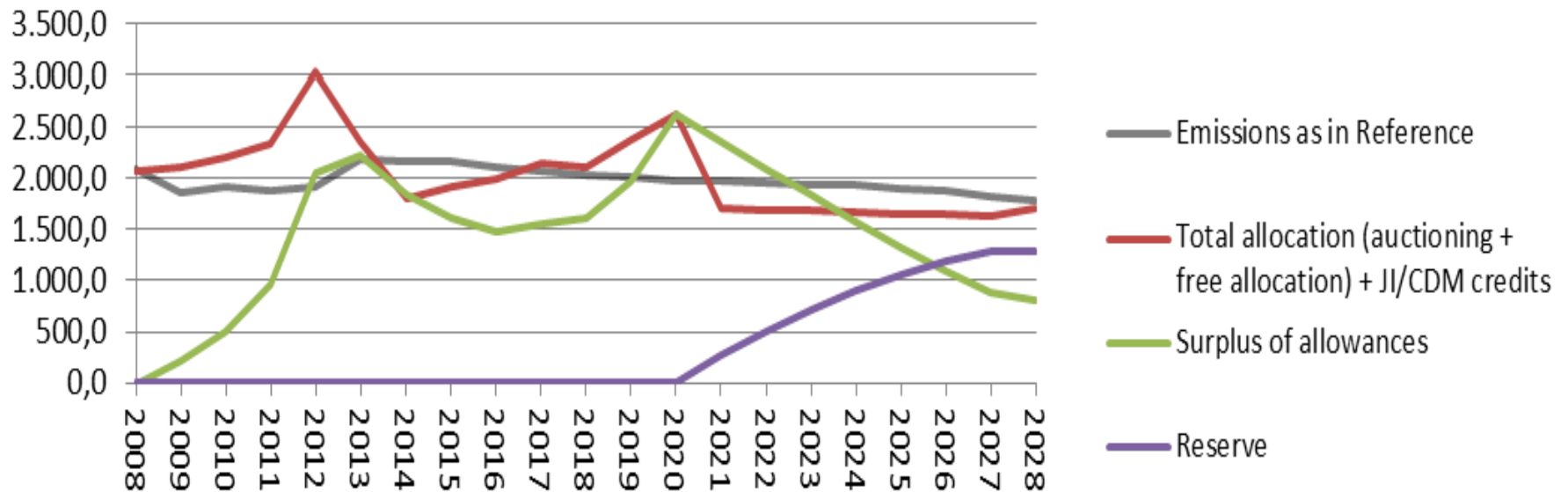
Releasing allowances:

- When surplus < 400 million EUAs
 - 100 million EUAs released
- If price higher than 3 times the average price over the last two years for more than 6 consecutive months
 - 100 million EUAs released
- 2 features:
 - Quantity-based trigger
 - Asymmetric

Market Stability Reserve Analysis I

- **What is the MSR achieving?**

- **Contributes to decrease surplus (due to exogenous shocks) of allowances in phase IV**
- **Might adjust the surplus to the hedging demand**
- **Might raise price in the short-term but...**



Source: European Commission (2014)

Market Stability Reserve Analysis II

- I. **Choice of quantity triggers (400-833 million tons):**
 - Repeated back-loading drama going on for next decade?
 - Speed of adjustment?

- II. **Can a temporarily adjustment of allowances cure the price discovery and push dynamic cost-effectiveness?**
 - Allowances come back to the market → not consistent with economic theory
 - Does not stabilize expectations / unclear signal
 - Impact on innovation and investment?

- III. **Unlikely to increase credibility of long-term commitment**

Conclusion

- **There is a wide range of reform options**
- **The appropriate option depends on both the goals attached to EU ETS and the driver(s) of the low price**
- **Delegation may help:**
 - **Increasing flexibility to adjust to ‘unknown unknowns’**
 - **Increasing credibility of long-term commitment / reduce uncertainty**
- **BUT not silver bullet:**
 - **Success will depend on its mandate**
 - **Democratic legitimacy**
- **Is the MSR delivering?**
 - **Difficult to assess but might induce regulatory uncertainty and unlikely to induce dynamic cost-effectiveness**

Thank you for your attention!



Bibliography

Grosjean, G., Acworth, W., Flachsland, C., Marschinski, R (2014).
After Monetary Policy, Climate Policy: Is Delegation Key to EU
ETS reform? MCC Working Paper.

Koch, N., Fuss, S., Grosjean, G., Edenhofer, O.: Review of price drivers in the EU ETS and new evidence on the impact of renewables, Work-in-Progress.

BACK UP



Commission's Reform Options (November 2012)

EU Set I: Reduce permit surplus	EU Set II: Adjust scope	EU Set III: Reduce Price Uncertainty
<ul style="list-style-type: none">• Increase the EU reduction target to 30 per cent by 2020• Retire a number of allowances in phase three• Early revision of the linear reduction factor	<ul style="list-style-type: none">• Expand the EU ETS to other sectors• Restrict the number of usable offsets	<ul style="list-style-type: none">• Discretionary price management, e.g.:<ul style="list-style-type: none">➤ Price floor➤ Soft price collar (allowance reserve)