

Views on the Market Stability Reserve

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- This report is based on CEPS' research and was informed by various meetings and consultations with EU ETS stakeholders.
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Issues for discussion

1. Is the MSR needed, and what problem(s) does it intend to solve?
2. What is the timing for the introduction of the MSR?
3. What are the options for governance?
4. What is the nature and level of thresholds?
5. What is the rate of input/output in the MSR?
6. How does it interact with other policies?

GHG Market Fundamentals

- EU ETS was conceived as a pure regulatory market whose stated objective is to “promote reductions of greenhouse emissions in a cost-effective and economically efficient manner”.
- The carbon market must function in line with the principles of sustainable development, in that the environmental and economic aspects must be balanced
- The market created by **the EU ETS has functioned well** as measured against some indicators

GHG Market Characteristics

- Is a **purely regulatory market, a construct, and one that is still.**
- The traded product can be seen as having the characteristics of both a **commodity and a currency.**
- **Demand fluctuates**, and is influenced by cyclical (economic) and structural changes (technology changes, interaction with other policies, etc.).
- **Supply is inelastic.** Supply flexibility has two aspects:
 - Free allocation (based on historical production levels, which can be divorced from the realities of the economic cycle)
 - Auctioning schedule (set well in advance).

The real objective of the EU ETS is good price discovery, in the context of meeting the 2050 environmental objective

Supply side flexibility mechanisms

- All carbon markets jurisdictions have introduced supply side flexibility mechanisms
- Based on price triggers
- Have not been tested
- There is the option of executive intervention

What problem are we trying to solve?

- **Symptom:** low prices that do not seem to reflect long term GHG scarcity
- **Effect:** not achieving *“aim of addressing the concerns that investment decisions were being made against the background of an oversupply of allowances, resulting in a less than economically efficient way of reaching the ambitious mid-to-long term EU greenhouse gas reduction objectives”*.
- **Cause: lack of flexibility on the supply side.**
- **Limitation:** The MSR can only address the lack of flexibility on the supply side which results from the fixed auctioning schedule. The lack of flexibility resulting from free allocation still needs to be addressed.

Timing for introduction of the MSR

- *If the MSR is needed, why wait?*
- *Does early introduction close the door on any other policy choices?*
- *What are the pluses and minuses associated with starting the MSR as soon as the legislative process would allow it?*

Timing for introduction of the MSR

Why Not

- Impact inside a trading phase
- Impact EUA prices and future competitiveness of EU industry, at a time when there is no clarity on the carbon leakage risk mitigation measures that will be put in place for the post-2020 period.
- Run contrary to the political commitment that was made in the backloading
- Some parameters of the MSR are interdependent with other components of the 2030 climate and energy package

Timing for introduction of the MSR

Why Yes

- Price signal that would be more in line with the signal from a market that would have had 'normal' elasticity of supply
- Earlier start-up of abatement measures, long term cost minimization.
- Avoidance of price volatility at the end of Phase 3
- Avoid reputational risk

The arguments in favour of prompt implementation of the MSR fully justify a prompt decision on this matter.

MSR interaction with other policies

- Treatment of the backloaded amount
- Renewable energy (RE) target
- Energy efficiency (EE) target
- Carbon leakage risk mitigation measures
- Article 29a of EU ETS

Amount of compliance units in the market

Nature of surplus

- Impact of the economic recession - cyclical
- Impact of the RE and EE targets through GHG reductions
- Mitigation actions undertaken by covered installations in response to carbon and/or energy prices.
- Influx of CERs
- Cyclical surplus vs. structural surplus
- ‘Bad’ surplus vs. ‘good’ surplus

Treatment of backloaded amount

If the MSR is accepted as a valid proposition, it seems to make little sense to re-inject the excess EUAs into the market, only to have the MSR work to have that excess removed.

-> Hence, the backloaded EUAs should be moved straight into the MSR

Carbon Leakage Risk Mitigation Measures

- Two sides of the same coin:
 - carbon prices (EUAs),
 - carbon costs (and impacts carbon leakage).
- Some industry see carbon leakage post-2020 and adoption of MSR take place on the same timetable. Lack of common timetable results in lack of support for MRS, even if they support MSR it technically.
- Little interaction between MSR and CL pre 2020
- Any interaction with post 2020 CL should be managed through governance provisions

Carbon Leakage Risk Mitigation Measures

- The MSR must be accepted on its own merits to ensure good market functioning, by addressing the inflexibility of the supply side of the market
- Carbon leakage risk mitigation measures are also an issue on their own
- There is no, or limited, technical linkage between CL post 2020, and MSR
- There is a legitimate negotiating linkage
- Points to the need to speed up CL, not to slow down MSR
- Carbon prices at 30 EUR/ton on the CLL
- Should indirect electricity costs get special attention before 2020?

Triggers/Thresholds & Value of Thresholds

- Trigger should be volumetric due to EU institutional arrangements
- Other less complex triggers possible but challenging due to EU governance
- Volumetric trigger works with market but has 2nd degree level of impact on symptom
- Additional triggers may be possible, and desirable, but add complexity
- Value of thresholds may be appropriate, but largely subjective
- Will need monitoring and review – data collection essential.

Governance

- The MSR must have a governance system that will react, within a credible timeframe, to changing conditions, in a consistent manner
- Main characteristics are predictability and flexibility
- Formulas will form the backbone of the MSR governance
- The MSR governance system must also include provisions that would allow human judgment to evaluate the situation, and set the direction and parameters at **inflection points**, for those parameters that may require such interventions

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