Preparing the Review of the MSR

Three « ice-breaking » remarks

ERCST – Preparing the Review of the MSR
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Three ice-breaking remarks

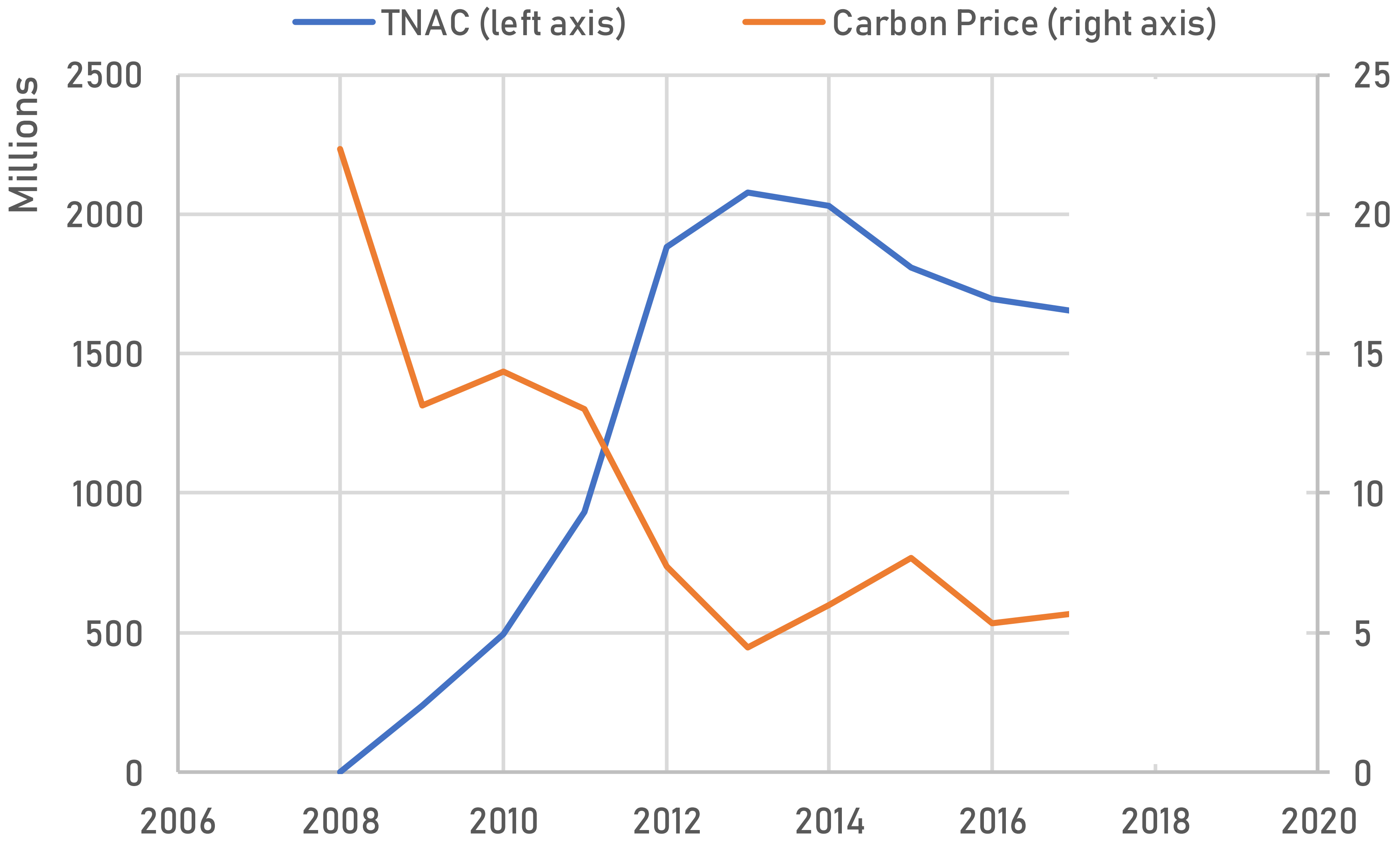
#1. Surplus and market balance

#2. MSR goal(s) revisited

#3. Price-triggered MSR is the easy way

+ Some results to come from our research

#1. Surplus and market balance



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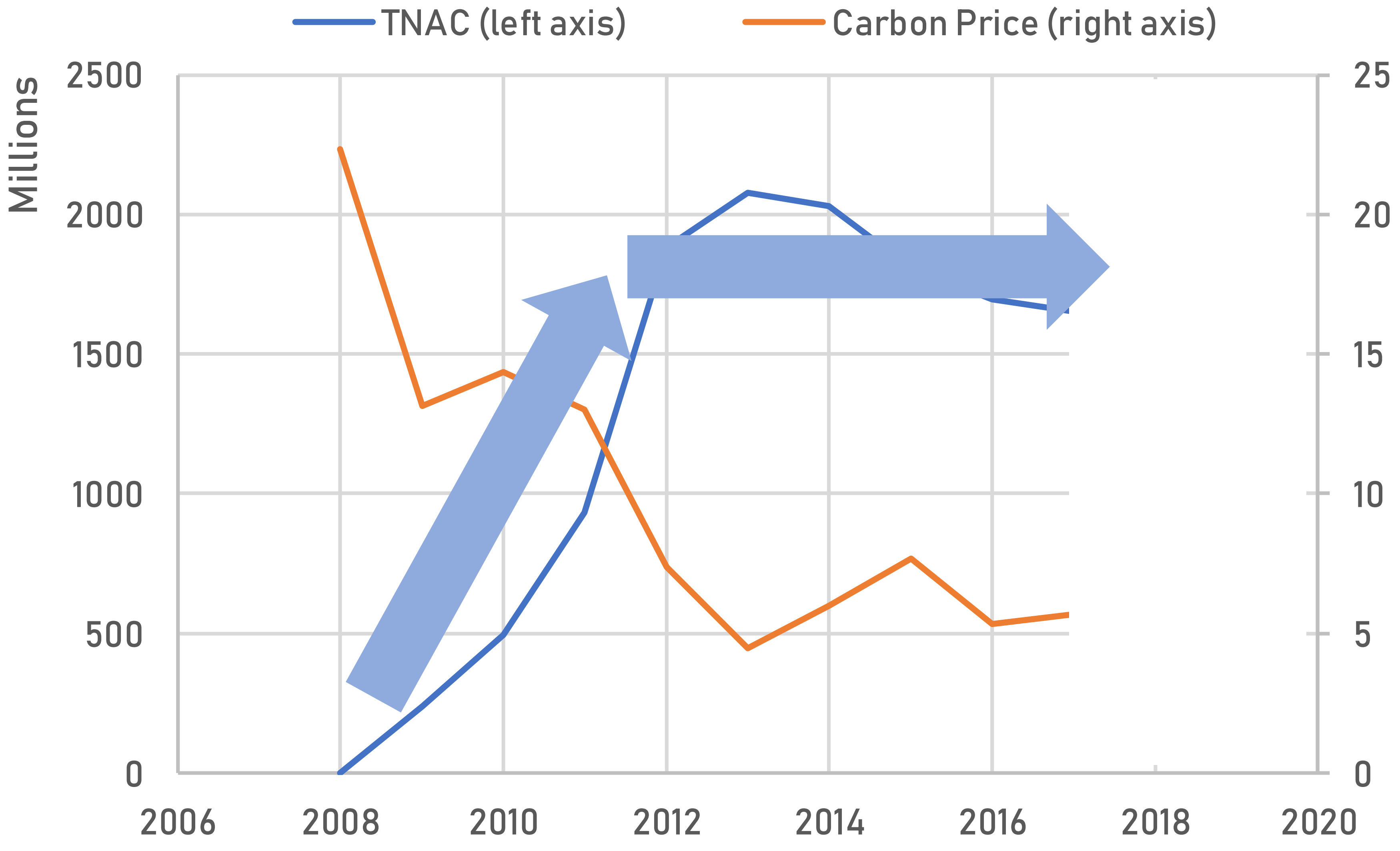

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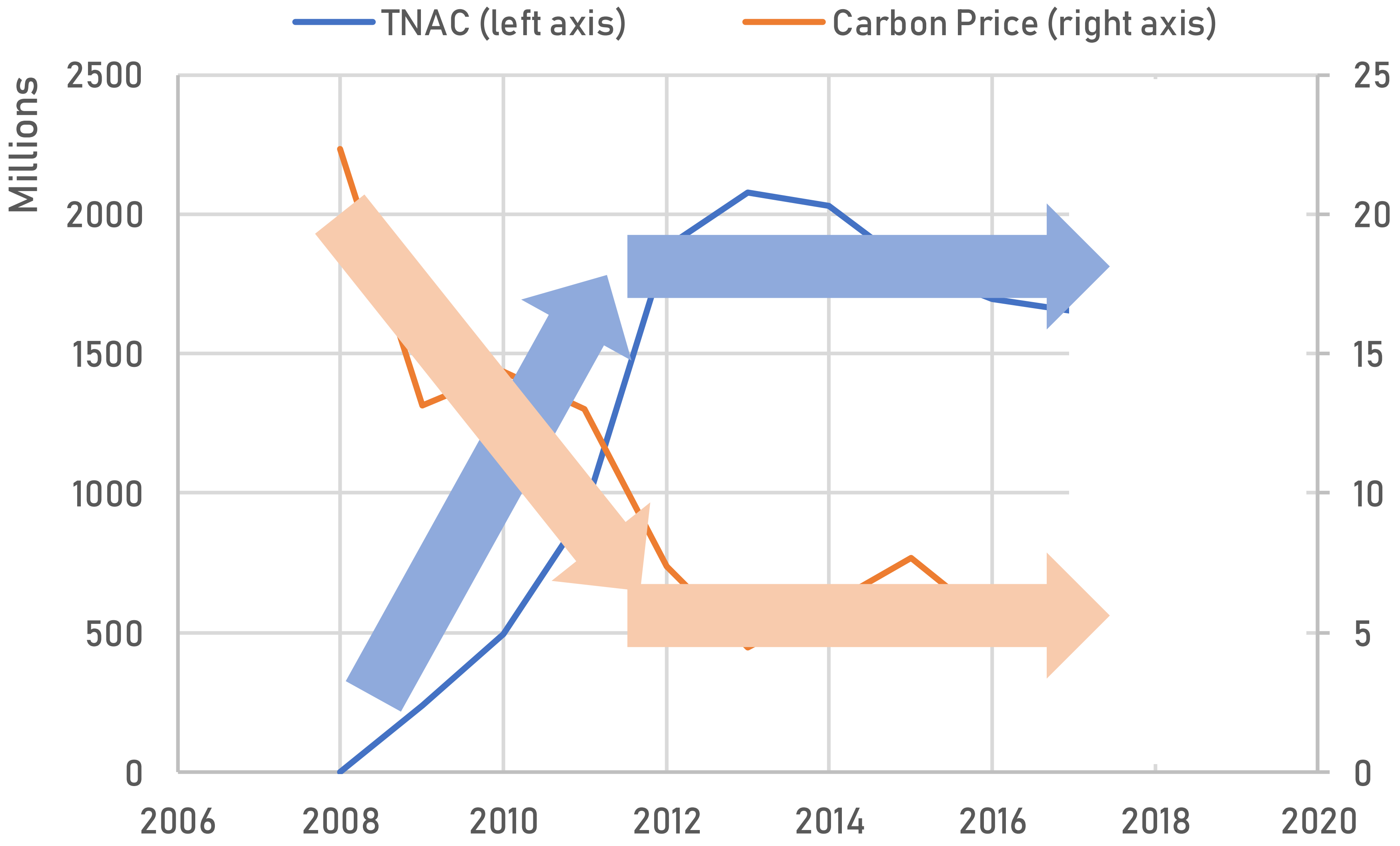

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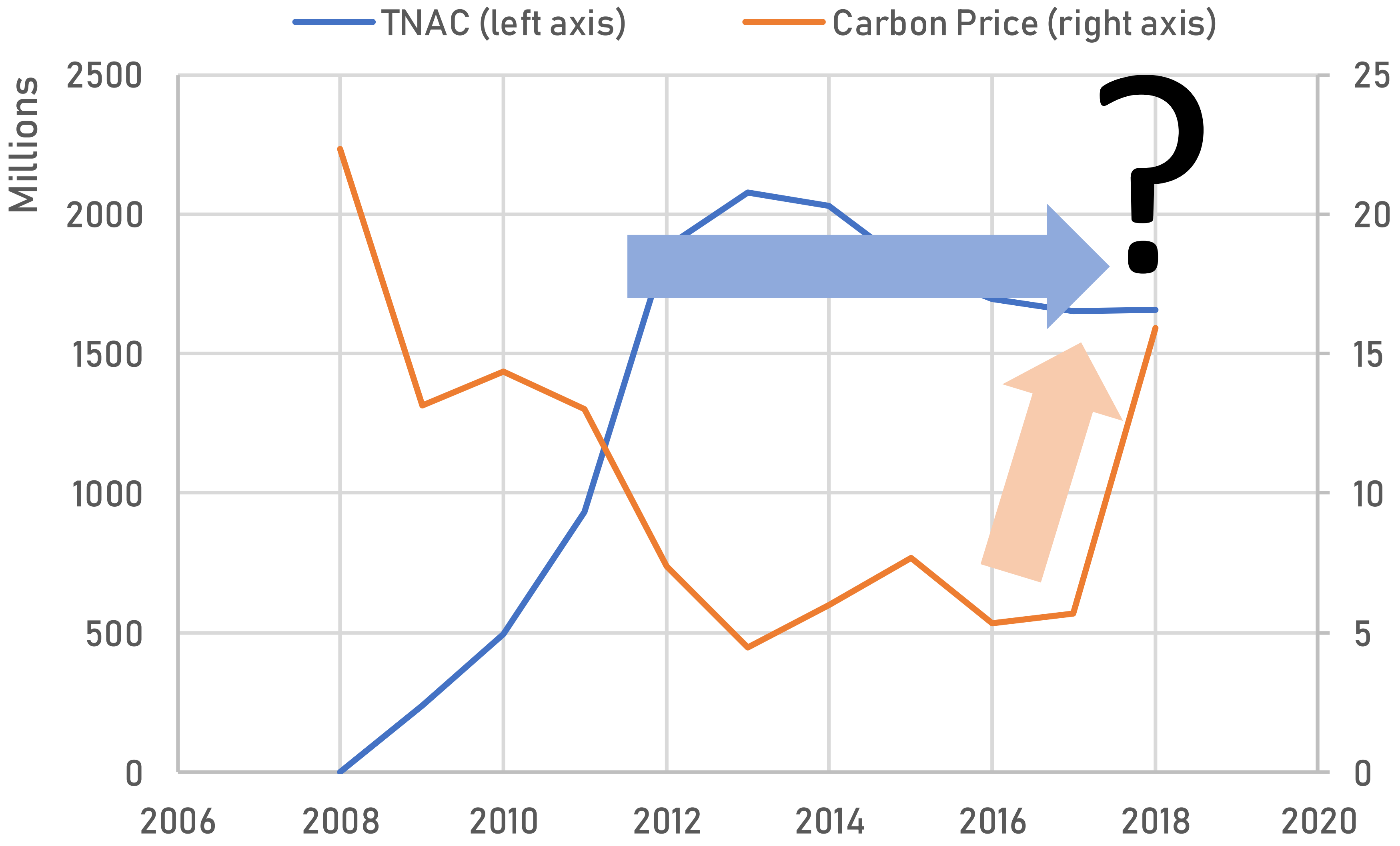

#1. Surplus and market balance

Market balance/imbalance is a tricky concept:

- Price reflects **expectations** of supply-demand imbalance, not current « physical » balance
- As long as the price is not zero, one could argue that the market is balanced
- Intertemporal arbitrage requires (and creates) some degree of « surplus » (hedging, speculation…)
- The **TNAC is not a good indicator of market balance** or market « health » (there is « good » surplus and « bad » surplus)
  - Good: carbon price driven ST reductions, MT/LT effects of carbon price triggered investments (new technologies and innovation…)

#1. Surplus and market balance

→ The recent price surge is due to the market anticipation of future MSR effects, not to actual removal of allowances (it happened before!)

→ Let's be careful and not confuse the level of the TNAC with the success/failure of the market (and more specifically of the MSR)

→ It is very difficult to define the « right » amount of « surplus » necessary for good market functionning

→ This appropriate amount is determined by the market, accouting for the MSR reaction. In other words participants know that if they hold on to surplus, they will make the cap get tighter

#2. MSR goal(s) revisited

The MSR is not here because of market imbalance, is it there because:

Simple answer:

- The price was too low

Complicated answer:

- There has been some undesired changes in **expected demand (economic crisis, RE, EE, national pol.)** and expected supply (offsets)
- It was **impossible to adapt the cap** in a reactive and reasoned way
- Probably for technical reasons, but above all **for political reasons**

→ The MSR was designed to **remove allowances from the market** (reinforce the cap), not to control such exogenous unexpected shocks

#2. MSR goal(s) revisited

→ To determine the threshold levels and intake parameters, the right question to ask should be how many allowances do we want to remove from the market and when?

- Current MSR setting is equivalent to setting the LRF at 2.95%, but by removing a lot early and less later

→ If we want a lot of allowances to be removed, the answer is to maintain the 24% (or even increase it…) and keep the thresholds where they are, or even lower them

→ If we want less allowances to be removed, or none, the answer is to lower the intake rate and have higher thresholds

→ In any case it is not reasonnable to fix those for five years

#3. Price-triggered MSR is the easy way

Major issues:

- We created an automatic robot to solve political problems, based on an indicator that does not indicate real issues…→ More problems to come

- The MSR acts with a delay of at least 1.5 years, but the price (and expectations) can adapt in 1 day (if not 1 second)

- We will struggle to define a desirable target TNAC corridor that stays valid for five years in face of ever-changing MS domestic policies (coal phase out…)

#3. Price-triggered MSR is the easy way

If we judge the success of the market on the level of the price, and that the price is the purest indicator for quick and transparent adjustments of the cap, why not just have a **price triggered MSR?**

We all know it's a no go for the moment…. But we have a political problem anyway, so why not deal with it « face to face »?

Two possible outcomes if we don't do it:

- Option 1: MSR removes so many allowances from the market that the price gets to 100+ €/t, and companies and MS freak out
- Option 2: Despite MSR absoptions, so much interactions from MS and EU policies that carbon price goes back below 5€/t

Some results to come from our research

Dauphine Université Paris
Climate Economics Chair

Even if carbon price triggered MSR is an option, we are reasonnable and work on possible changes of:

- MSR intake rates
- MSR thresholds
- …in the presence of policy interactions (coal phase out…)

→ We evaluate the effect of reformed MSR designs on carbon price, cap changes, intertemporal efficiency, **« waterbed » control**…

We would be happy to share our results over the summer and discuss them with the group!

Thank you for your attention

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