



# Preparing the review of the Market Stability Reserve

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Roundtable on  
Climate Change and  
Sustainable Transition

# ERCST work on the MSR review

## Meetings:

- February 2019 – conference call on the MSR review
- March 2019 – stakeholder meeting “Preparing the review of the MSR”
- July 2019 – stakeholder discussion on the TNAC publication and the MSR
- September 2019 – presentation of ERCST draft paper on the MSR review

## Final launch of ERCST paper:

- **November 18, 2019**

## Outline of the paper

1. Introduction: how did the MSR come into play
2. Framing the MSR review
  1. Definition of the MSR goals
  2. Definition of the goal of the MSR review
  3. Definition of market balance for the purpose of the MSR review
  4. Definition of “reasonable amount of time” for the MSR to tackle market imbalances
3. Proposed structure of the review
4. Indicators to monitor towards the review

# The legal basis for the MSR review

- Article 3 of the MSR Decision requires, periodically, an assessment of the MSR functioning and the delivery of its objectives (reviews scheduled in 2021 and 2026).
- Art. 3 indicates that the MSR review should be developed *‘on the basis of an analysis of the orderly functioning of the European carbon market’*, adding that **some elements to be included** in the analysis are:
  - **the MSR intake rate** (*‘the percentage figure for the determination of the number of allowances to be placed in the reserve’*);
  - **the continued appropriateness of the upper and lower thresholds** (*‘the numerical value of the threshold’*);
  - **and the relationship of the Reserve with competitiveness issues** (*‘impact of the reserve on growth, jobs, the Union’s industrial competitiveness and on the risk of carbon leakage’*).
- However, Art. 3 does not clarify how the analysis should be carried out, nor what the structure of the review should be.

## Aim of ERCST paper

- Try and put forward practical proposals on how the review should be structured
- As a starting point, we assume that the MSR review should be centred on the Reserve's ability to meet its stated goals, as indicated by the legislation.
- In other words, the review should answer the following questions:
  - **is the MSR delivering upon its goals?**
  - in case the MSR would not be delivering, what are the **reasons behind its under-performance?**
  - **what changes might this imply to the legislation?**

## Two goals of the MSR: addressing historical and new imbalances

- The MSR Decision highlights **2 goals of the MSR**:
  1. *Eliminate the historical structural supply-demand imbalance “within a reasonable amount of time”;*
  2. *Bring the TNAC within range of the MSR thresholds in case of new events, “within a reasonable amount of time”*
- **New events**: changes from the regulatory scenario that the regulator had anticipated when establishing the parameters, which might lead to new supply-demand imbalances on the market.

# One goal of the MSR review: competitiveness concerns

- Additionally, there is a **third goal of the review:**
  3. *assessing the impact of the MSR on growth, jobs, and competitiveness*
- The emphasis of the MSR Decision on competitiveness issues points to the fact that this should be evaluated as a key and separate element in the MSR review.

## Two necessary premises

1. what is a “**market balance**”, as opposed to market “imbalances”?
  2. what can be considered as a “**reasonable amount of time**”?
- Both Goal 1 and Goal 2 refer to historical and new potential sources of “imbalance”, to be dealt with by the MSR “within a reasonable amount of time”.
  - Before continuing the discussion on the MSR review, these two elements need to be clearly defined.



## Market balance

- The MSR Decision does not provide with a definition. Moreover, there is no existing definition of “market balance”. What is generally used is “market equilibrium”, which is defined by the state in which market supply and demand balance each other, and, as a result, prices become stable.
- In the context of the role of the MSR in the EU ETS framework, **we believe that the EU ETS “market balance” could be defined according to two elements:**
  - a) **current scarcity on the market, to be identified according to the TNAC being within thresholds**, as defined by the MSR Decision;
  - b) **future expectation of market scarcity in the EU ETS**, which is driven by both market and political expectations.

## Market balance

### a) Current scarcity: TNAC level

*As the MSR is a formula-driven mechanism, the analysis of the short-term market balance cannot refrain from a discussion on the TNAC level*

### b) Future expected scarcity

*Future market and political expectations may also influence price discovery, and should be considered to assess the MSR role in improving the market balance*

- Attention should also be given to understanding what are the **TNAC composition and its different components**, looking at how the market participants make use of the existing surplus

## Reasonable amount of time

- The MSR Decision does not make an explicit reference to the expected pace of reduction of the surplus.
- However, **just achieving a reduction of the surplus would not be sufficient for the MSR to fulfil a positive role** – the MSR always improves the EU ETS ability to deal with imbalances, compared to a scenario with no-MSR in place.
- The focus of the review should be on **what period of time would be “reasonable”, or “fast enough” for the MSR to play a positive role.**
- If the EU ETS is to promote cost-effective decarbonisation, we assume **3 to 5 years** as being a **“reasonable” timeframe for the MSR to absorb imbalances** on the market, given that 3-5 years is the average time for businesses to take investment decisions (IEA, 2019).

# Structuring the 2021 review

## Proposed structure of the review in 3 parts:

1. The first part should develop a **list of indicators for each of the three goals**, taking into account the elements stated in Article 3.
2. The second part should assess the effectiveness of the MSR in meeting the three goals, to be analysed through the study of the **indicators' performances**. This assessment will serve as the basis to evaluate the continued appropriateness of the existing MSR parameters (intake rate, thresholds, cancellation mechanism).
3. The third part should examine the **possibility for the MSR to assume new goals in the future**, if any.

# List of indicators to monitor the MSR performance

<b>Goal 1 – Eliminate the historical structural imbalance</b>	<b>Goal 2 – Bring the TNAC within range of the MSR thresholds in case of new events</b>	<b>Goal 3 – Monitor the impact of the MSR on competitiveness</b>
<p><u>Indicators for Goal 1:</u></p> <ul style="list-style-type: none"> <li>• TNAC for 2019-2021</li> <li>• Estimated TNAC for Phase 3 compared to TNAC for 2019-2021</li> </ul>	<p><u>Indicators for Goal 2:</u></p> <ul style="list-style-type: none"> <li>• RES/EE achievements of MS in 2020 vs. 2020 targets</li> <li>• Yrs. to absorb variation caused by RES/EE targets towards 2030</li> <li>• Yrs. to absorb variation caused by overlapping MS policies (e.g. coal phase outs)</li> <li>• Yrs. to absorb variation caused by changes in economic growth</li> <li>• Cumulative impact of all the previous indicators for Goal 2</li> <li>• Alignment of hedging strategies to MSR thresholds</li> </ul>	<p><u>Indicators for Goal 3:</u></p> <ul style="list-style-type: none"> <li>• Carbon leakage impact of EUA price (both direct and indirect costs)</li> <li>• Change in auction revenues for MS caused by the MSR</li> <li>• Implications of the MSR functioning on the innovation and modernisation funds</li> </ul>

# Performance of MSR according to the indicators

- **Under Goal 1:**
  - assess if the TNAC declines at a sufficient pace, and if the reduction of the surplus accelerates in the years of the MSR operations (2019 to 2021) – absolute decline vs. pace of reduction of the “historical surplus”, to be compared to the definition of “reasonable amount of time” (3-5 years).
- **Under Goal 2:**
  - compare the period needed for the MSR to absorb new potential imbalances caused by different sources (e.g. RES/EE targets, MS coal phase-outs, economic shocks, etc.), with the definition of “reasonable amount of time” (3-5 years).
- **Under Goal 3:**
  - assess the impact of EUA prices and of EU ETS-related costs on competitiveness, jobs and growth, taking into account both negative and positive impacts.

## Open questions

- Definition of “market balance”, as opposed to “market imbalances” on the EU ETS.
- Role of the TNAC as an indicator of the MSR performance, and TNAC composition.
- Appropriateness of the identified Goals of the MSR (Goal 1 and 2) and the goal of the review (Goal 3).
- List of indicators – new indicators? On competitiveness, how to assess the impact of the MSR on jobs?
- How to coordinate the MSR review with other potential changes to the EU ETS framework? (e.g. changes to the cap or the LRF)