



POTSDAM INSTITUTE FOR
CLIMATE IMPACT RESEARCH

Preparing for the review of the EU ETS: Dealing with supply-demand imbalance and review of the MSR

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Member of



More of the same or something different?

This meeting will focus on how the EU ETS review should address policy overlap, supply-demand imbalances and approach the mandated review of the Market Stability Reserve. It will address questions such as:

- What is the outlook on the supply and demand of allowances in the market over the next decade?
- How should the Market Stability Reserve to be reviewed, and **its appropriateness be assessed?**
- What other policy tools can be considered to address the issue, including:
 - voluntary/mandatory cancellation of allowances;
 - **price-based tools such as a price floor, a price corridor,** or a central carbon bank;
 - other governance arrangements.

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What is wrong with the MSR, actually?

“It is the basic setup of the MSR – it using the TNAC as an indicator – that is at the heart of the problem.” (G.P.)

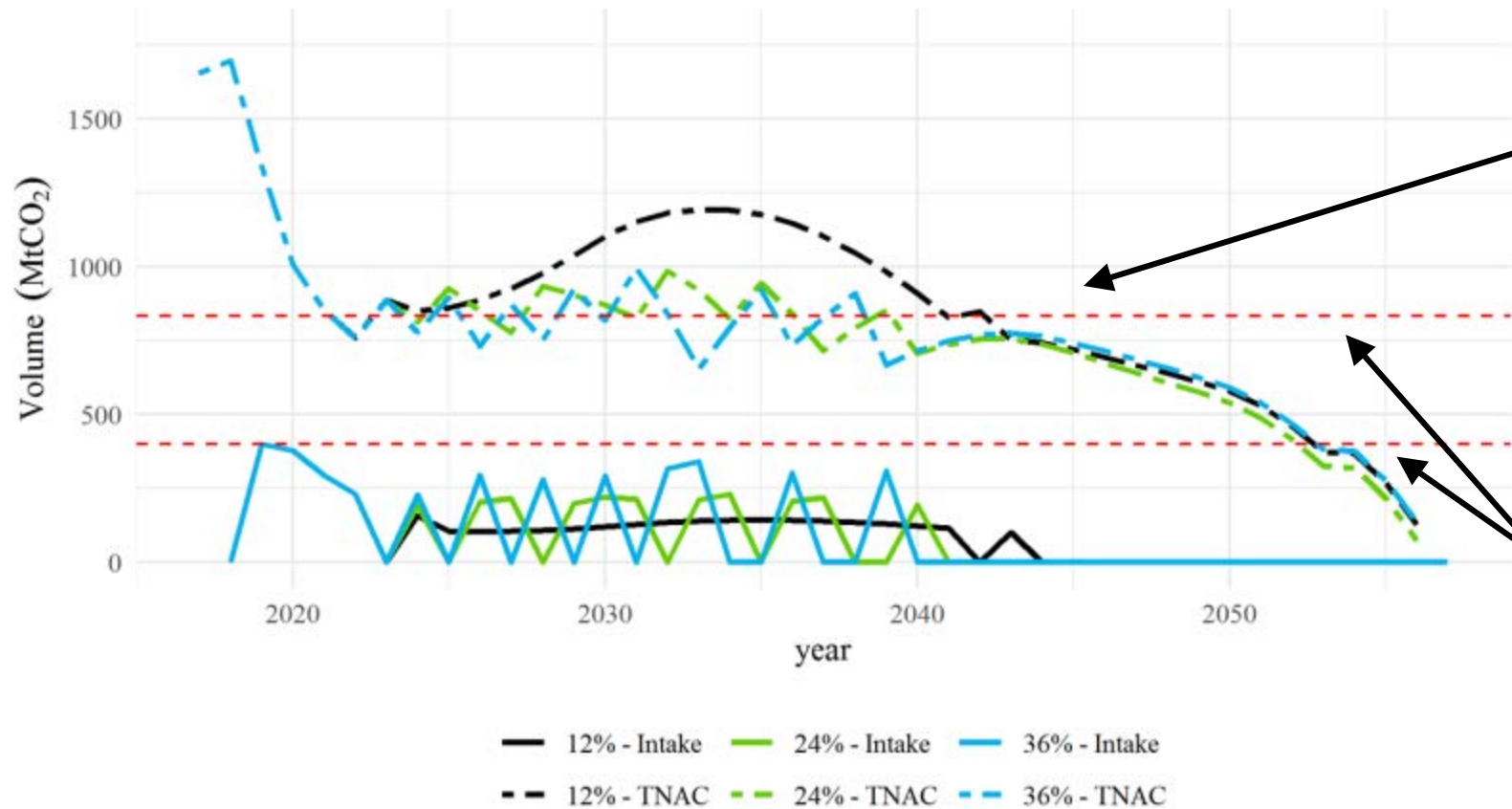
The TNAC → price **non-relationship**

- In the **past**, using TNAC as trigger made sense for **reducing surplus**
 - In the **future**, increasing “resilience to shocks” essentially sole objective → **price is the only meaningful indicator**
 - However, practically and theoretically $p \neq f(TNAC)$ but $p = f...$
 1. expectations about market fundamentals, including overlapping policies
 2. expectations about regulatory changes of the ETS
 3. speculation about these expectations
 4. overall sentiment in the market
- TNAC just a **tiny and rather erratic factor** in #1 and potentially #2
- Using TNAC to stabilize prices is like **controlling the speed of a car by opening/closing its windows**



See our
review!

TNAC trigger even destabilizes prices



Oscillation around intake threshold (room for speculation)

Corridoring = erroring: hedging or speculative holdings?

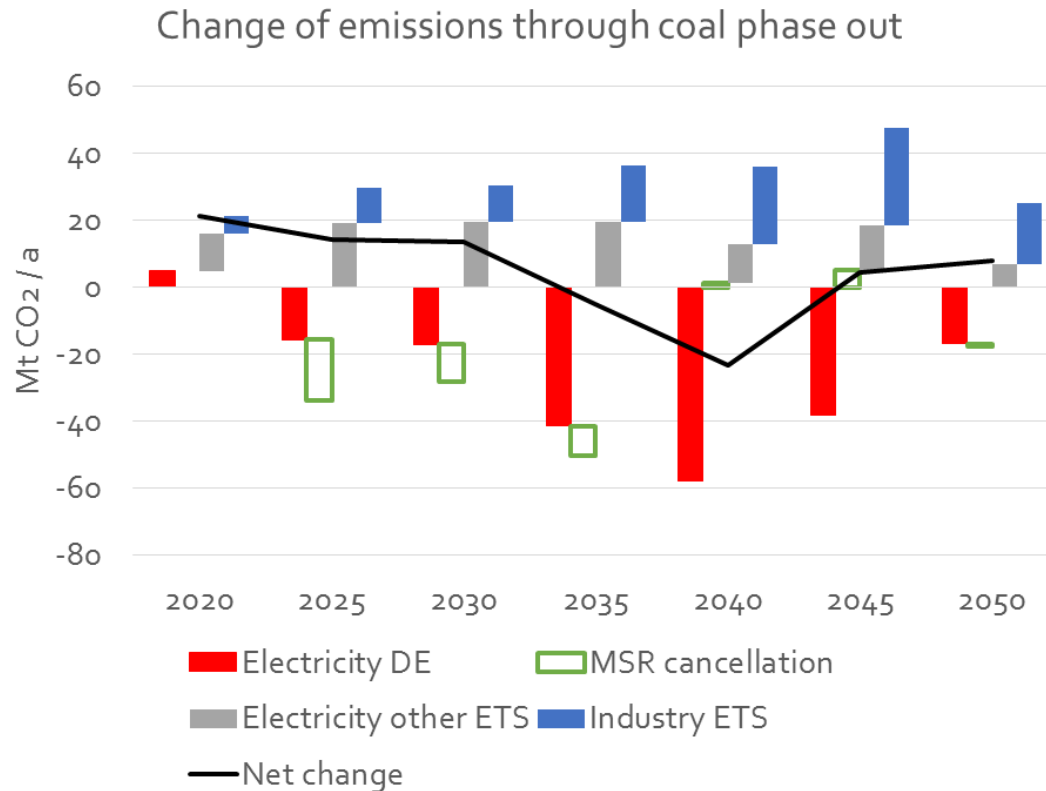
 **sparkchange**

Spark Change is a technology platform that simplifies investing in carbon instruments.

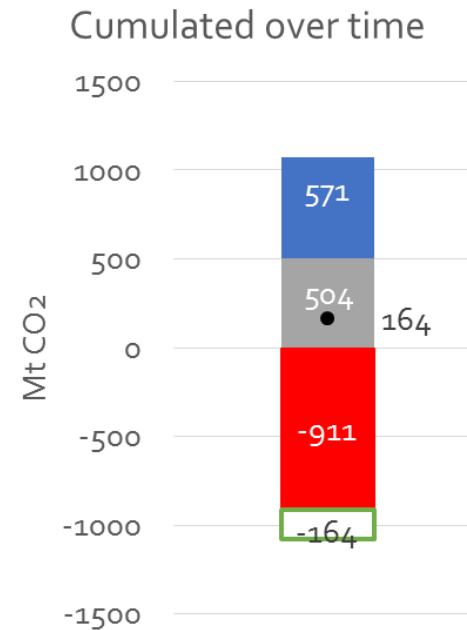
Source: Pahle & Quemin (2020), based on PIK analysis

$TNAC = f(p_t, p_{t+1}, \dots)$ renders Article 12(4)-ish adjustments for overlapping policies highly erroneous

German coal phase out



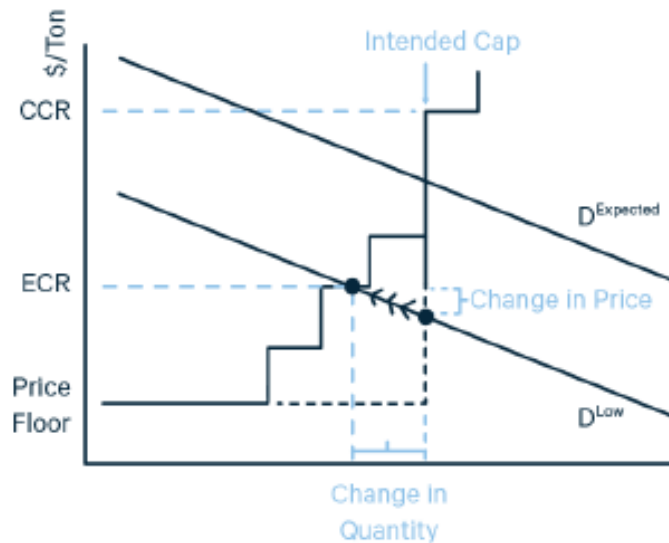
Source: PIK (Pahle et al. 2019)



- Future demand changes (overlapping policies) affect current prices
 - ...which affect TNAC
 - ...which affects cancelations
- **Pseudo-calculation** of additional emission reductions (net MSR canc.) essentially **just another (price) uncertainty**

From MSR to **Price Stability Reserve**

- Replacing the TNAC (indirect control) with the allowance price (**direct control**) simplifies attaining stability considerably
- That is what the **Price Stability Reserve** proposal is all about (proof of concept and design blueprints in US programs)



*A **price-responsive supply schedule** would share the effect of low demand [from overlapping policies] between reduced price and emissions. [...] There could be **multiple price steps** associated with **specified quantities**.*

Source: RFF (Burtraw et al. 2019)