

POLICY BRIEF

EU ETS Directive Review: A focus on the Article 29a

Summary

The EU ETS Directive, as currently designed, provides two instruments to act when EUA prices fall outside what is perceived as acceptable boundaries: the Market Stability Reserve (MSR) , and the Art 29 of the EU ETS Directive addressing price imbalances. So far these instruments are not interlinked, being different from other jurisdictions under ETS regime.

Before any modifications to the current rules are implemented, the role of the EU policy maker is to understand the reasons why some sectors of the society are concerned about the current carbon price escalation. Being able to answer fundamental questions about the role of carbon prices, the right definition of market abuse, when intervention in the carbon market is justified, and the role of financial institutions in the carbon market and its impact on contributing or destroying decarbonisation value are a must if we are to come up with the best fit-for purpose design.

Authors

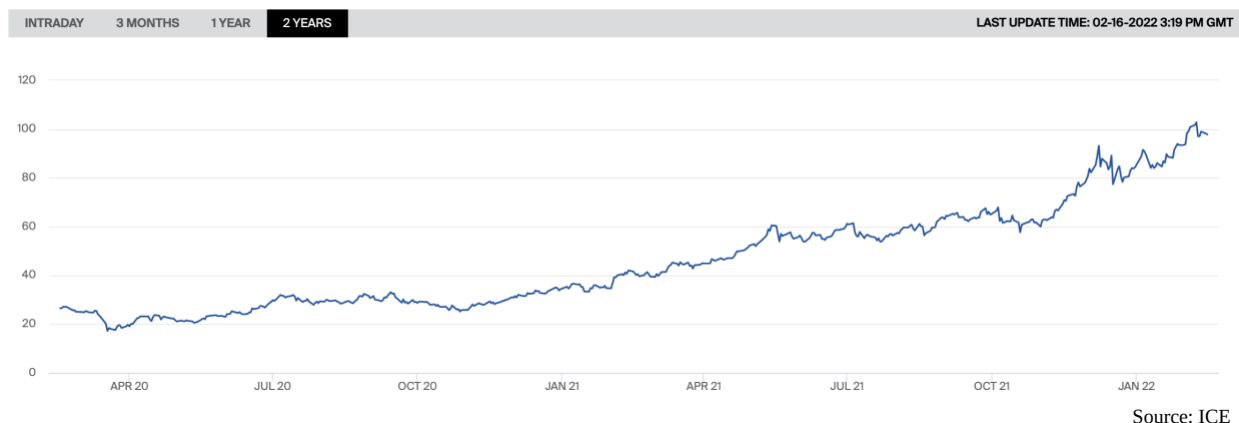
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1. What are the interlinkages between the EU carbon and energy market?

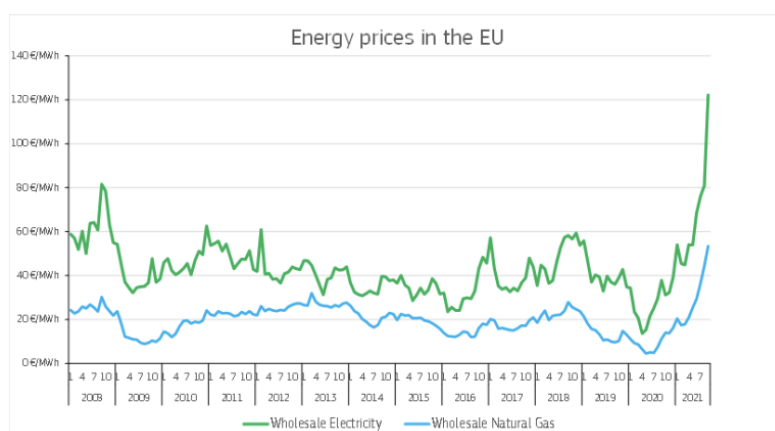
The European carbon market has experienced a sharp price increase during the last years. While on February 17th 2020 the carbon price was 26.46€/tons of CO₂, on February 8th the same indicator reached 102.83€/tons of CO₂¹. This means a 288,62% carbon price increase in a two-year period.



While the carbon price has experienced a progressive sustained evolution across the last 2 years, the energy prices, as driven by the wholesale electricity and natural gas MWh price, have experienced a rapid increase since the end of 2020². The price of natural gas went from around 10€/MWh in 2020 to more than 50€/MWh in 2021. This extraordinary increase can be explained by geopolitical factors³ and the increased global demand for gas, in particular linked to the COVID crisis recovery⁴. In the case of electricity, the price went from 18€/MWh to more than 120 €/MWh in 2021.

EUA price volatility was blamed for volatility in energy prices, to different degrees by different stakeholders, as well as competitive pressures on industry. This has triggered calls for the re-examination of Art 29a of the EU ETS Directive that addresses issues around price volatility.

In this context, the Czech Senate produced on November 25th a National Parliamentary Reasoned Opinion on Subsidiarity calling to address “the



¹ ICE EUA Futures Dec 2025. Available at: <https://www.theice.com/products/197/EUA-Futures/data?marketId=5474739&span=3> (Accessed on 16 February 2022)

² European Commission (2021): “Tackling rising energy prices: a toolbox for action and support”. COM (2021) 660 final. Pp 3. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021DC0660&from=EN> (Accessed on 16 February 2022).

³ Vitelli, A (2022): Euro Markets: Carbon dips amid volatile energy markets as intervention calls grow. Carbon Pulse. 15 February.

⁴ EC (2021). “Tackling rising energy prices: a toolbox for action and support”. COM (2021) 660 final. Pp 2.

absence of mechanisms preventing speculative trading with emission allowances⁵”. Spanish authorities raised similar concerns highlighting that “the EU ETS trading should not be available to all agents, especially not to speculators with market power⁶” while the Polish Government has recently called to introduce control mechanisms to the bloc’s carbon market and curb financial speculators’ participation in the scheme⁷”. Energy-intensive industries have also voiced concerns that the current price spike is harming their competitiveness.

2. Which are the current instruments available to the policy maker?

The EU ETS Directive, as currently designed, provides two instruments to act when EUA prices fall outside what is perceived as acceptable boundaries: the Market Stability Reserve (MSR) , and the Art 29 of the EU ETS Directive addressing price imbalances. So far these instruments are not interlinked, being different from other jurisdictions under ETS regime.

MSR

The MSR is a quantitative measure based on the amount of allowances in circulation, with a clear impact on EUA prices. In this sense it is slower to react, and it is seen more as a long-term measure.

The MSR is regulated by Decision (EU) 2015/1814⁸, and has been in operation since January 2019. Under the current rules, the MSR operates by removing allowances from the carbon market by modifying the auctioning schedule when the Total Number of Allowances in Circulation (TNAC) is outside the set thresholds. An intake rate has been used annually to transfer auction volumes to the MSR. Starting in 2023, allowances held in the MSR above the previous year’s auction volume will be invalidated⁹.

The EC has recently proposed to strengthen the MSR rules. Notably, it proposes to double the intake rate (24%) until 2030, and modify the upper and lower thresholds (1096 million allowances and a lower threshold of 833 millions of allowances).. In addition, allowances in the MSR above 400 million are to be cancelled.

Art 29a

Art 29a of the EU ETS Directive was included in Directive 2009/29/EC to address excessive price fluctuations¹⁰. Under Article 29, if, for more than six consecutive months, the allowance price is more than three times the average price of allowances during the two preceding years, the EC shall convene a meeting

⁵ European Parliament (2021). Reasoned opinion of the Czech Senate on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC, Decision (EU) 2015/1814 and Regulation (EU) 2015/757. Committee on Legal Affairs. Pp. 4. 25 November.

⁶ Non-paper on energy and electricity markets. Pp. 1. Available at: <https://www.politico.eu/wp-content/uploads/2021/09/20/20210920-Non-Paper-on-Energy-markets.pdf> (Accessed on 18 February 2021).

⁷ Gotev. G. (2022): “Poland calls on EU to remove ‘speculators’ from its carbon market”. EuroActiv. 16 February. Available at: <https://www.euractiv.com/section/climate-environment/news/poland-calls-on-eu-to-remove-speculators-from-its-carbon-market/> (Accessed on 18 February 2021).

⁸ Decision (EU) 2015/1814 of the European Parliament and of the Council of 6 October 2015 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC.

⁹ In 2021 the ERCST produced a paper explaining the operation of the MSR. The paper is accessible at: <https://ercst.org/wp-content/uploads/2021/04/20210429-Final-Paper.pdf> (Accessed on 18 February)

¹⁰ Directive 2009/29/EC of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community.

of the Climate Change Committee¹¹. This is just a first condition for the Art29a to be triggered. As a second condition, the EC Climate Change Committee has to determine that the excessive price fluctuations do not correspond to market fundamentals, while no definition of market fundamentals is given by the legislator.

Only if both conditions are met, the Article 29a is triggered. If this is the case, there are two tools available to Member States: (1) A measure which allows to bring forward the auctioning of a part of the quantity of allowances to be auctioned; (2) A measure which allows to auction up to 25% of the remaining allowances in the New Entrants Reserve. So far, the Article 29a has never been triggered.

3. Analysis

It is clear that there are many ambiguities in the current language of Art 29a, which can only create uncertainty in the EU ETS market, at a time when EUA prices have fluctuated dramatically from 5-6 Euros in 2017 to almost 100 Euros in 2022, only to drop back in the 50 Euro range

Given this background, there are several elements in the current Article 29a of the EU ETS Directive requiring thorough examination:

- The vague and unclear wording creates significant market uncertainty as to the timing and type of a potential market intervention by the regulator. A market which is already quite volatile needs more transparency and regulatory predictability, not less. The current wording would seem to provide a significant degree of freedom to the regulator without clearly defined guidelines. The lack of predictability makes it more complicated for ETS compliance entities to anticipate the evolution of the carbon price, and to set the right framework to trigger investments in decarbonisation, rather than incentivising short-term speculative behaviour.
- Besides predictability, market transparency is an essential element, and this is in no way detailed in the current wording. In many ways, transparency, and predictability, work hand-in-hand. For illustration purposes, the UK ETS has many transparency provisions that give the price containment mechanism more credibility.
- There are significant definitions lacking from the current text for Art 29a. Market fundamentals are not defined. In addition, excessive price volatility may need to be addressed even in the context where there are market fundamentals that justify significant price fluctuations and there is no evidence of market abuse. The current wording seems to totally exclude that option. Price is also referred to in the text, without any clarity as to what price is being considered (spot, Dec delivery, etc.)
- Furthermore, a clear link between the two mechanisms (MSR and Article 29a) may be reconsidered under a common carbon market. A good example is the UK Carbon Cost Containment Mechanism which, under its article 12 (1.d.)¹², allows the British Treasury to release allowances from the market stability mechanism account held by the UK ETS Authority for auction in that calendar year. The MSR was never intended to be an additional mechanism to set the ambition, and the EUAs in the MSR should be tapped when it is justifiable.

¹¹ The Climate Change Committee (C13600) meets periodically to discuss and approve different legislation related to climate, including EU ETS secondary legislation requiring the approval of Member States through implementing acts. Files voted under this group include auctioning, benchmarks and monitoring of CO2 emissions, among others.

¹² The Greenhouse Gas Emissions Trading Scheme Auctioning Regulations 202. Part 3 Auction Calendar. Art 12. Available at: <https://www.legislation.gov.uk/ukdsi/2021/9780348220049/contents> (Accessed on 18 February 2022)

- Art 29 and other price containment mechanisms use a trigger as a starting point. The final decision is made by a committee. This begs two different questions. Firstly, if the trigger is a guidance but not a final decision, which requires a committee decision in this case, one must inquire why that is not also the case for the MSR, with much more significant implications. The second issue that needs to be raised is that of timing and governance. In the case of the UK ETS the trigger is, in its early years, much more sensitive in terms of threshold, and there is a governance structure in place that allows it to react quickly. The governance for the EU ETS needs to be adapted to the same type of governance that will allow the timing to work with market realities, not the political pace of EU institutions that cannot mimic the market speed.
- In addition, recognising the regulatory nature of the EU ETS and its objectives and setting a clear but different path for compliance and non-compliance market participants is important. This is in no way meant to detract from the importance of financial institutions in market functioning and price discovery, this cannot be emphasised enough. This need not be commensurate and only in extraordinary circumstances. A good example is given by the Californian Price Sailing Sale, where authorities may offer price s to covered entities to purchase what they need to meet their compliance obligations¹³.

Before any modifications to the current rules are implemented, the role of the EU policy maker is to understand the reasons why some sectors of the society are concerned about the current carbon price escalation. Being able to answer fundamental questions about the role of carbon prices, the right definition of market abuse, when intervention in the carbon market is justified, and the role of financial institutions in the carbon market and its impact on contributing or destroying decarbonisation value are a must if we are to come up with the best fit-for purpose design.

¹³ 2021 price ceiling sale was 65\$ per allowance. The price sailing price increases 5% plus inflation every year.