



Preparing the review of the Market Stability Reserve

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ERCST

Roundtable on
Climate Change and
Sustainable Transition

ERCST work on the MSR review

Meetings:

- October 2018 – meeting on the impact of the new Clean Energy Package targets on the EU ETS
- 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
- October 2019 – presentation of ERCST draft paper on the MSR review

Launch of ERCST paper:

- **November 18, 2019**

Outline of the paper

1. Introduction: the origins of the MSR
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 MSR review
4. Indicators to monitor towards the review
5. Looking forward: the MSR review as part of a broader reform to the EU ETS framework?

The origins of the MSR

- The functioning of the EU ETS has long been impacted by a structural surplus of emission allowances.
- First reform: backloading of 900 million EUAs in 2014-2016 (temporary measure, agreed on in 2011).
- The impact assessment accompanying the MSR Decision indicated that the surplus would not go away, and without further measures it would remain at around 2 billion allowances throughout Phase 4.
- As a long-term solution to fix the EU ETS demand-supply imbalance, a **Market Stability Reserve (MSR) was adopted in 2015, to start operating in January 2019.**

Design characteristics of the MSR

- The MSR Decision included different mechanisms to address the accumulated surplus on the market, as well as to improve the EU ETS responsiveness to future shocks.
- These measures can be summarised as follows:
 - a) all unallocated **allowances from the “backloading” are transferred to the MSR;**
 - b) the Reserve is designed to release/absorb allowances to/from the market according to some pre-set thresholds:
 - **100 million allowances to be released from the MSR if the total number of allowances in circulation (TNAC) is below 400 million EUAs;**
 - **fixed percentage of the TNAC to be placed in MSR if the TNAC is above 833 million EUAs (intake rate of 12%).**
- *TNAC = Supply – (Demand + allowances in the MSR)*

Design characteristics of the MSR

- The reform of the EU ETS Directive in 2018 introduced changes to this framework, *‘considering the need to deliver a credible investment signal to reduce CO2 emissions in a cost-efficient manner and with a view to strengthening the EU ETS’*.
- 1. Intake rate of the MSR was increased from 12% to 24% until 2023;**
 - 2. Yearly invalidation of allowances above the number of allowances auctioned the year before was created** (“cancellation mechanism”). This invalidation is set to start in 2023, and aims at cancelling part of the surplus of EUAs held in the MSR at that point in time.

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:
 - i. the MSR intake rate** (*‘the percentage figure for the determination of the number of allowances to be placed in the reserve’*);
 - ii. the continued appropriateness of the upper and lower thresholds** (*‘the numerical value of the threshold’*);
 - iii. 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, it seems reasonable to assume that **the MSR review should be centred on the reserve's ability to meet its stated goals**, as indicated by the relevant 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?**

General approach behind the MSR

- Looking at the broad picture, it can be affirmed that the rationale for having a Market Stability Reserve, as opposed to *potential alternatives*, is to ensure:
 - a) the predictability in market intervention** (i.e. stability of governance);
 - b) automatic adjustments of the volumes in the market**, in order to bring the supply-demand balance within a certain desirable bandwidth, as established by the regulator.
- *Potential alternatives?*
 - a) if the intention of the EU institutions was simply to address the built-up surplus, a one-off intervention might have been sufficient;
 - b) to tackle the existing and (potential) future supply-demand imbalances, the regulator could have acted on prices instead of volumes, via, for instance, the introduction of a price floor, a price corridor, or a central carbon bank.

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 in 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 review.
 - This is not to say that the MSR should be seen as the instrument to address each and every implication of the EU ETS on competitiveness, but only that **the review should evaluate if the MSR is having an impact on these “competitiveness concerns”.**

Two necessary premises

- i. what is a “**market balance**”, as opposed to market “imbalances”?
 - ii. 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, there is price discovery.
- 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

- The two points should be considered together, as neither of them, on its own, would be sufficient to define the EU ETS 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

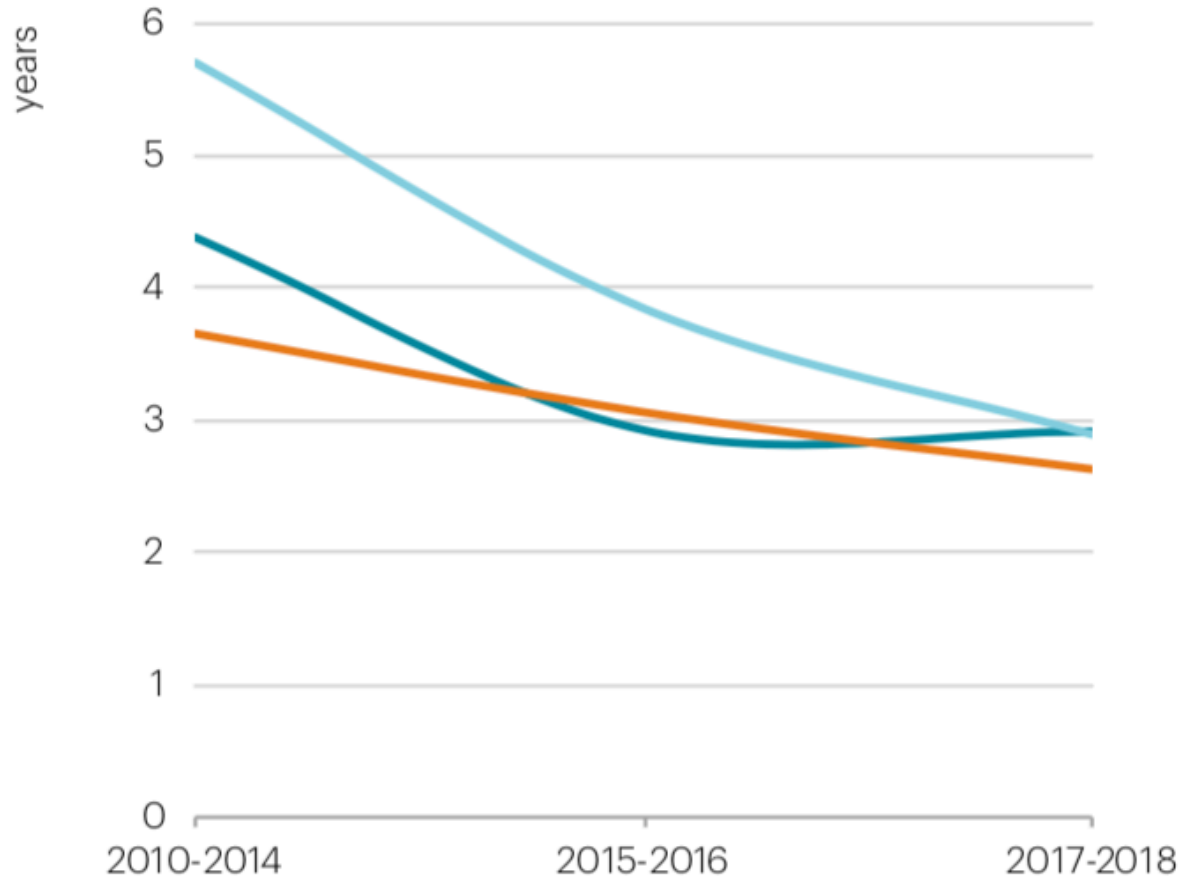
Future market and political expectations may also influence price discovery, and should be considered to assess the MSR role in improving the market balance

TNAC composition

- Emphasis should also be put on examining the **different components of the TNAC**, seeking to understand how these different components are influenced by, and have an influence on the current and future expected scarcity.
- **Market participants make use of the existing surplus in different ways:**
 - *hedging needs three years ahead, free allowance banked for future use and no longer available for the market, allowances used for compliance today, etc.*
- **Looking at the TNAC as a single entity would not show what volumes are actually available to market players:** the review should capture these nuances as part of the assessment of the MSR performance.
- In the future, the review should also analyse whether **aviation allowances** should be included in the TNAC formula, in order to avoid potential misinterpretations of the EU ETS “market balance”.

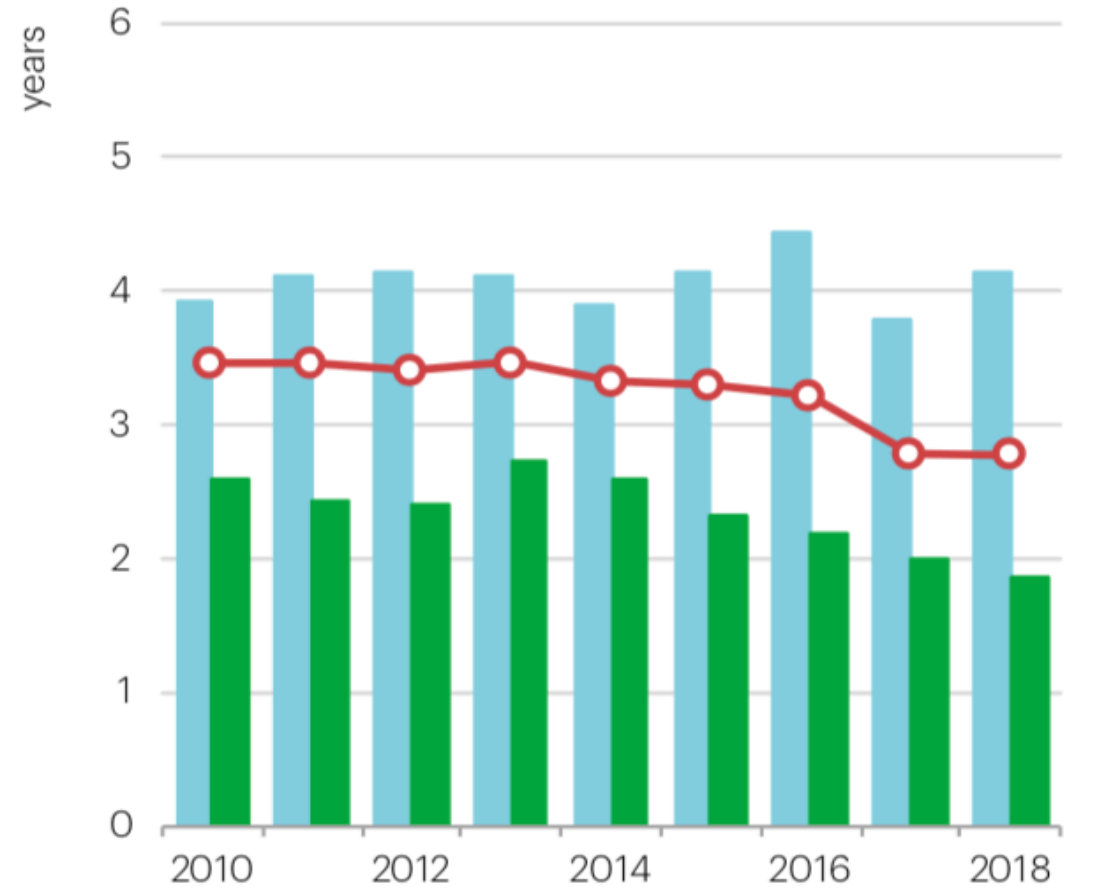
Reasonable amount of time

Average time to market for conventional oil and gas projects



— Deepwater — Offshore shelf — Onshore

Average power generation construction time (capacity weighted)



— Thermal power — Renewable power — All generation

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 evaluation 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.

Track-record and forward-looking analysis of the MSR performance

- If the review were to focus only on the track-record of the MSR, this would result in a fairly limited exercise, both in terms of scope and information available:
 - *as the MSR starts its operations in 2019, any assessment based on its track-record would translate in analysing data and indicators for just two years of operations (e.g.: in 2021, only the 2019 and 2020 TNAC will be available).*
- The review should therefore look at both the track-record of the MSR until 2021, as well as at its expected performance in the period to 2030.
- **This forward-looking analysis could be included in the review through indicators based on modelling exercises and stress tests**, assessing the expected impact of some conceivable “new events” that might affect the market towards 2030 (e.g. announced policies at the EU and MS level, economics shocks, etc.)

Indicators to monitor towards the review

Goal 1 – Eliminate the historical structural imbalance	Goal 2 – Bring the TNAC within range of the MSR thresholds in case of new events	Goal 3 – Monitor the impact of the MSR on competitiveness
<p><u>Indicators for Goal 1:</u></p> <ul style="list-style-type: none"> a. TNAC for 2019-2020 b. Estimated TNAC for Phase 3 compared to TNAC for 2019-2020 c. Estimated number of allowances invalidated in 2023 compared with the difference between the 2018 TNAC and the MSR upper threshold 	<p><u>Indicators for Goal 2:</u></p> <ul style="list-style-type: none"> a.1. Yrs. to absorb variation caused by RES/EE achievements of MS in 2020 vs. 2020 targets a.2. Yrs. to absorb variation caused by RES/EE targets towards 2030 b.1. Yrs. to absorb variation caused by overlapping MS policies (e.g. coal phase outs) in the period 2019-2020 b.2. Yrs. to absorb variation caused by overlapping MS policies (e.g. coal phase outs) for the period to 2030 c.1. Yrs. to absorb variation caused by changes in economic growth in the period 2019-2020 c.2. Yrs. to absorb variation caused by changes in economic growth towards 2030 d. Cumulative impact of all the previous indicators for Goal 2, to be estimated through a comparison of different modelling scenarios indicating the long-term trend of the TNAC towards 2030 e. Alignment of hedging strategies to MSR thresholds 	<p><u>Indicators for Goal 3:</u></p> <ul style="list-style-type: none"> a. Carbon leakage impact of EUA price (both direct and indirect costs) b. Change in auction revenues for MS caused by the MSR c. Implications of the MSR on the innovation and modernisation funds

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 (2019-2020), also looking at the amount of allowances expected to be invalidated in 2023 – ***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.

Looking forward: the MSR review as part of a broader reform to the EU ETS framework?

- When ERCST started its series of meetings on the MSR review, the EU ETS framework seemed to be set in stone.
- Today, the situation has changed, with talks currently ongoing about revisiting the EU's CO2 reduction target for 2030 and expanding the EU ETS coverage to new sectors.
- **If the intention of the new European Commission is to significantly modify the EU ETS framework, then the MSR review should be structured as part of a broad and comprehensive reform to the EU carbon market.**
- This would help **limit regulatory uncertainty** as opposed to the past, when the 2015 MSR Decision was substantially amended only a few years after its adoption, through the 2018 EU ETS Directive.
- Furthermore, this would ensure that **any change to the MSR is weighed against possible alternative options, approaching a potential reform to the EU ETS framework in a coherent and concerted way: the MSR should not be seen as a *silver bullet* to all sorts of ills.**