



The EU ETS Market Stability Reserve Coping with COVID-19 and preparing for the review

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Roundtable on
Climate Change and
Sustainable Transition

Background: The origins of the MSR

- The functioning of the EU ETS has long been impacted by a structural surplus of emission allowances.
- First patchwork solution: ‘backloading’ of 900 million EUAs in 2014-2016: auctioning postponed until 2019-2020 (temporary measure).
- As a long-term solution to fix the EU ETS demand-supply imbalance, the **Market Stability Reserve (MSR) was adopted in 2015, to start operating in January 2019.**

Background: Design characteristics of the MSR

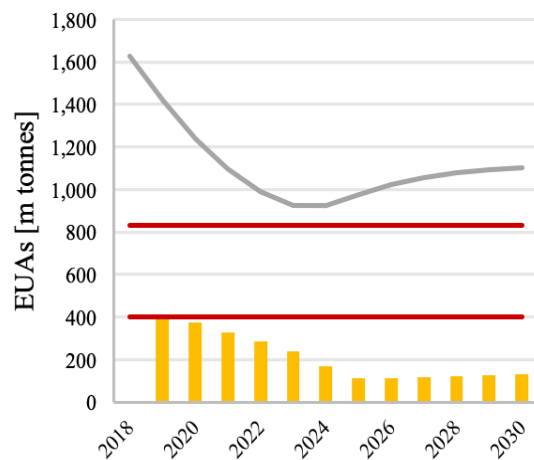
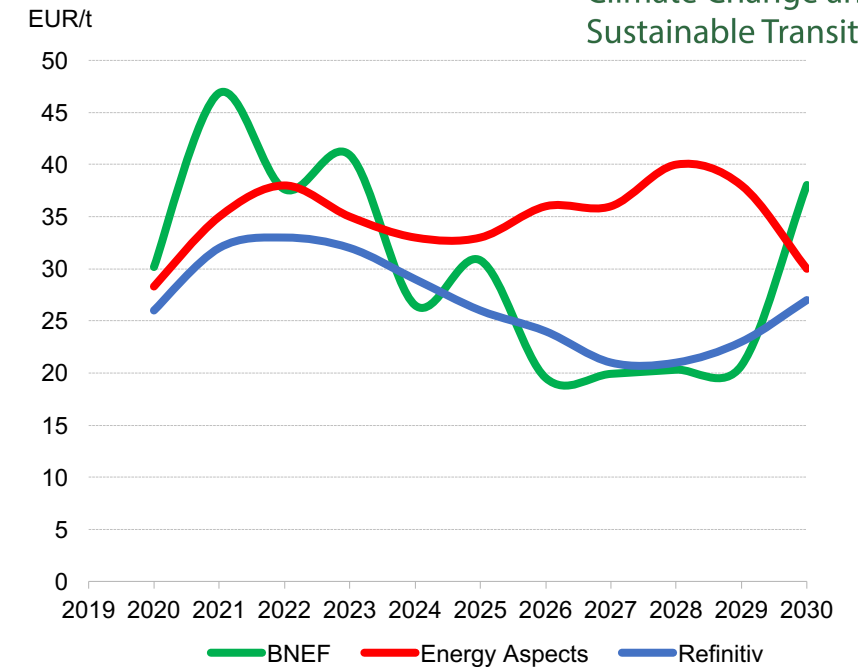
- **2015 MSR Decision:**
 - a) all unallocated allowances from the “backloading” are transferred to the MSR;
 - b) the Reserve is designed to release/absorb allowances to/from the market according to pre-set thresholds:
 - 100 million allowances to be released from the MSR if the total number of allowances 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%).
- **2018 Phase 4 EU ETS revision changed the MSR framework:**
 - a) Intake rate of the MSR was doubled to 24% until 2023;
 - b) Yearly invalidation of allowances above the number of allowances auctioned the year before was created (“cancellation mechanism”), starting from 2023.

Background: MSR Review

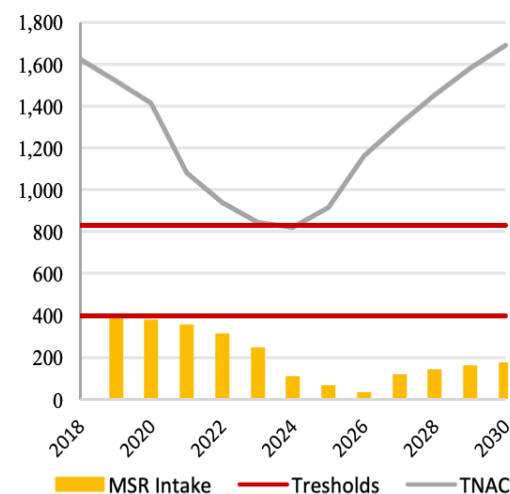
- Two reviews of the MSR are mandated during Phase 4: in 2021 and 2026.
- The MSR review should analyze whether the MSR is delivering upon its goals:
 - a) Eliminate the historical structural supply-demand imbalance *within a reasonable amount of time*;
 - b) Bring the TNAC within range of the MSR thresholds in case of new events *within a reasonable amount of time*
- On top of that (*as stipulated by the Directive*) the review should also ‘assess the impact of the MSR on growth, jobs, and competitiveness’
- Analysis of the track-record + forward-looking analysis

Background: pre-2020 situation

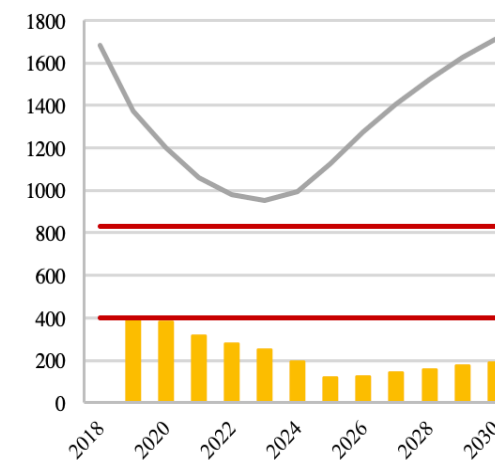
- **2018/2019:** EUA prices on the rise
 - Interpretation: MSR will do/is doing its job
- **Early 20s:** year-on-year undersupply of the market + decreasing TNAC – prices are expected to continue to rise
- **After 2023:** expectations that TNAC will increase again + prices will start to drop



Source: ERCST elaborations on the European Commission, 2018; and modelling by the Weqener Center, 2019



Source: ICIS, 2019



Source: ERCST assumptions and Sandbag modelling, 2019

The MSR in 2020: a different world

- **The European Green Deal**

- Climate-Neutrality by 2050 – *European Climate Law*
- Expected increase in 2030 target – *2030 Climate Target Plan by September 2020*
- Revision of the climate and energy framework – *proposals by June 2021*

- **COVID-19**

- Shutdown of countries → lower economic activity → lower emissions
 - Structural changes?
- Recovery Plan for Europe + Plans of individual Member States

➔ It is important to put the MSR review into the context of these new realities

1) Analyzing the track-record of the MSR - understanding the role of the MSR in dealing with the impacts of COVID-19

- COVID-19 induced economic crisis: first real ‘**stress test**’ of the MSR
- Reaction of many stakeholders is to **look at price developments**
 - General sentiment seems to be that prices held up well and bounced back quickly.
 - Not only influenced by COVID-19 and the functioning of the MSR: there are other *bearish and bullish* elements at play.
 - Interesting to understand what role the MSR functioning really played.
- **In light of the review itself:**
 - Price considerations should not be the primary focus, as the MSR is a volume-based instrument.
 - Quantitative assessment of the surplus resulting from the crisis and assess whether the MSR is able to cope with it.

2) ‘Future-proofing’ the MSR when emission pathways are uncertain

- Next to assessing its track-record, the review should also ‘future-proof’ the MSR parameters
- **Forward-looking analysis:** what is the baseline ‘emissions pathway’ under current policy developments?
- **Currently a high degree of uncertainty:**
 - European Green Deal implementation;
 - Shape of the recovery + structural impacts of the crisis;
 - Implementation of the recovery plans.
- The MSR review will have to take into account these uncertainties, and the MSR should be made fit for purpose and be able to cope with a wide variety of potential emission pathways under the EU ETS.

3) As the whole ETS framework is now up for revision – is the MSR still the critical element?

- The MSR review now needs to be **put in the context** of what can potentially be a broad and comprehensive review of the EU ETS.
 - ⇔ 2019 sentiment: MSR review as ‘silver bullet’ to all sorts of ills
- It is necessary to ‘take a step back’, look at the EU ETS in its entirety, and decide what role the EU ETS is to play in the future decarbonization efforts of the EU.
- With that role in mind, we can then look at the role of different policy options on the table, of which **the MSR is only one of many.**

4) Implications of an explicit 2050 climate-neutrality goal for the EU ETS?

- EU-wide climate-neutrality ambition is expected to soon be enshrined into law.
- **Question:** Will a net-zero target change the mindset and behavior of compliance actors and other market participants?
 - Some argue that current market dynamics have not fully reflected the long-term market scarcity/long-term marginal abatement costs beyond 2030;
 - Could an explicit net-zero goal impact the investment/banking strategy of market participants?
- Is an explicit long(er)-term target for the EU ETS necessary?

5) Towards revenue maximization?

- Auction revenues increased significantly in recent years.
- Recently, the Commission's updated MFF and recovery package proposal included an **EU ETS-based own resource** to fund part of the repayment of funds to be raised under Next Generation EU.
- **Question:** is revenue maximization becoming a (more important) element on the mind of policymakers?
- If so, this could have implications for the MSR review, as well as make certain options more 'attractive' for policymakers (*e.g. introduction of a price floor/corridor; extension to other sectors*)

MSR review: 5 issues for discussion

- 1) Analyzing the track-record of the MSR - understanding the role of the MSR in dealing with the impacts of COVID-19
- 2) 'Future-proofing' the MSR when emission pathways are uncertain
- 3) As the whole ETS framework is now up for revision – is the MSR still the critical element?
- 4) Implications of an explicit 2050 climate-neutrality goal for the EU ETS?
- 5) Towards revenue maximization?