

## **The EU ETS Market Stability Reserve**

### **Coping with COVID-19 and preparing for the review**

*Background note – 16<sup>th</sup> June 2020 meeting*

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## **Background**

The Market Stability Reserve (MSR) Decision<sup>1</sup> was adopted in 2015, with the goal of providing a long-term solution to what was referred to as the ‘*structural supply-demand imbalance*’ in the EU ETS. The MSR works as a volume-based instrument whose main function is to provide flexibility on the supply side of the EU ETS, by adjusting the supply of allowances to be auctioned, whenever the total number of allowances in circulation (TNAC) falls outside of a predefined range.

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 summarized as follows:

1. all unallocated allowances from the “backloading”<sup>23</sup> are transferred to the MSR;
2. the MSR will release/absorb allowances to/from the market according to some pre-set thresholds:
  - a. 100 million allowances to be released from the MSR if the TNAC is below 400 million EUAs;
  - b. fixed percentage of the TNAC to be placed in MSR if the TNAC is above 833 million EUAs (intake rate of 12%).

In 2018, as part of the Phase 4 EU ETS review, the MSR was strengthened. First, the intake rate of the MSR was increased to 24% until 2023. Second, a yearly invalidation of allowances above the number of allowances auctioned the year before was introduced (the “cancellation mechanism”). This cancellation mechanism is set to start from 2023, and will cancel a large part of the surplus of EUAs held in the MSR at that point in time.

Two reviews of the MSR are scheduled during Phase 4, one in 2021 and one in 2026. In ERCST’s view<sup>4</sup>, the MSR review should analyze whether the MSR is delivering upon its two goals:

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

On top of that, as stipulated by the Directive, the review should also ‘assess the impact of the MSR on growth, jobs, and competitiveness’.

The review itself *should* be twofold. Indeed, the scope should not be limited to an analysis of the ‘track-record’ alone, but rather seeks to do its evaluation taking into the expected future impact of the MSR throughout Phase 4, and ensure ‘future-proofing’ the MSR. This is especially true for the first review in 2021, as only 2-3 years of data will be available.

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<sup>1</sup> Decision (EU) 2015/1814. Retrieved from: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015D1814&from=EN>.

<sup>2</sup> The ‘backloading’ decision from 2011 was the first attempt of the EU institutions to ‘fix the system’, by patching it up. This reform, which was always presented temporary and ad-hoc measure, postponed the auctioning of 900 million allowances for the period 2014-2016 until the years 2019-2020, in an attempt to increase the market scarcity through a reduction of the supply of allowances.<sup>5</sup> “Back-loading” helped contain the quantity of EUAs that came to market, in the short-term and temporarily.

<sup>3</sup> Commission Regulation (EU) No 1210/2011. Retrieved from: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1210&from=EN>.

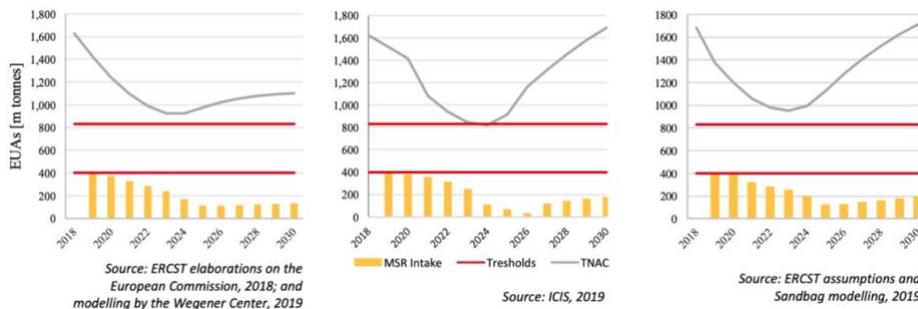
<sup>4</sup> <https://ercst.org/publication-review-of-the-msr/>

## **Pre-2020 situation**

While the MSR is a volume-driven and not a price-driven instrument, many stakeholders viewed the steady rise in EUA prices during 2018 and 2019 as an indication that the MSR is doing/will do its job. Indeed, while the surplus remains high, the increase in prices reflected market expectations of future scarcity. Many analysts expected prices to keep on rising in the early 20s, mainly resulting from the fact that a year-on-year undersupply on the market is expected in those years where the MSR intake rate is 24%.<sup>5</sup>

However, from 2024 onwards, when the intake rate is reduced to 12%, most analysts were in agreement that the TNAC will rise significantly by the end of Phase 4, in turn resulting in depressed prices.

Figure 1: projections of MSR functioning and intake volumes 2019-2030



Half a year later, the context of the upcoming MSR review has changed completely. The goal of climate-neutrality by 2050 is now supported by all three EU institutions, and is expected to soon be enshrined into law through the European Climate Law.

Moreover, as part of the European Green Deal, an increase in the 2030 ambition is also expected, and the Commission will propose its plan to revise the headline target to 50%, and possibly towards 55%, by September 2020. To deliver upon this increase in ambition, the entire Energy and Climate Framework will also be reviewed, including the EU ETS, for which the proposal is expected by June 2021.

More recently, Europe and the rest of the world have been hit by COVID-19, and the measures put in place to address the health crisis are having strong impacts on the economy, accompanied by significantly lower CO2 emissions in 2020, and potentially leading to lower production and emission levels long beyond 2020.

**As a consequence, it is important to put the MSR review into the context of these new realities.** In order to stimulate a discussion, five issues are raised in this background note. These issues should not be seen as ‘truths’ in any way, but simply serve as ‘food for thought’ for the [June 16 meeting](#) organized by ERCST.

<sup>5</sup> <https://ercst.org/publication-2020-state-of-the-eu-ets-report/>

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

The COVID-19 induced economic crisis can be seen as a first real ‘stress test’ of the MSR. The decline in economic activity in Europe is being accompanied by significantly lower CO2 emissions, and will add to the surplus of EUAs on the market, which the MSR will have to deal with.

The natural reaction by many stakeholders is to look at price developments. Mid-March, EUA prices dropped by €9 within a week to €15. Since then, they have steadily bounced back, and are holding above €20 since mid-May. The general sentiment seems to be that prices held up relatively well, and that this (in part/mainly) is because of the MSR.

It is important to reflect on this, and decompose, to the extent possible, these market dynamics, which of course are a result of a combination of factors. Currently, there are both *bearish* and *bullish* elements at play: next to the impacts of COVID-19, mild weather conditions and low gas prices are resulting in lower demand for EUAs. On the other hand, there are elements supporting the price, including the current MSR functioning, the anticipation of higher targets as part of the European Green Deal, and the expectation that the MSR review will result in higher intake rates.<sup>6</sup> The question that poses itself is thus how to detangle the effects of the MSR from other price drivers?

Having said that, while a discussion on EUA prices remains important in the context of the MSR functioning, price considerations should not become the primary focus of the review. The implication would be an MSR driven by price and not quantity, which is not, up to now, in the DNA of the MSR, nor of the EU ETS for that matter.

In light of assessing the ‘track-record’ of the MSR in the 2021 review, rather than looking at price developments, the surplus resulting from the COVID-19 induced economic shock should be quantified, and it should be seen whether the MSR is able to absorb this surplus within a reasonable amount of time. Of course, quantifying the surplus is inherently difficult as well, and is dependent, among other things, on the shape of the recovery.

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

Next to assessing its track-record, the review should also try to ‘future-proof’ the MSR parameters. Such a forward-looking analysis should be based on modelling exercises, estimating a baseline ‘emissions scenario’ under current policy measures, and ensuring that the MSR parameters are fit to deal with this scenario.

While such an exercise inherently brings a degree of uncertainty with it, this uncertainty is arguably a lot higher in the current situation. Firstly, the European Green Deal has announced new climate targets and new climate policies, whose impacts are currently still unclear. Moreover, Member States will have to develop or enhance their climate policies in order to achieve the increased ambition, which will only happen in the coming years.

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<sup>6</sup> <https://www.refinitiv.com/en/resources/special-report/global-carbon-market-report>

Secondly, as was mentioned above, it is still unclear what ‘shape’ the recovery will have, or whether any structural shifts in the economy will occur due to COVID-19. This is important, as it could impact the cumulative emissions emitted under the EU ETS.

Lastly, the implementation of the recovery plans will also greatly impact the future emissions pathways. If we indeed will see a ‘green recovery’ taking place in the EU, this could result in greatly accelerated emission reductions.

The MSR review will have to take into account these uncertainties, and should be made fit for purpose to cope with a wide variety of potential emission pathways under the EU ETS.

### **3) We are now looking at the whole ETS framework – is the MSR still the critical element?**

As part of the European Green Deal, the entire Climate and Energy framework will be revisited. This implies that we should put the MSR review in the context of what can be expected to be a broad and comprehensive review of the EU ETS. As such, the MSR review should also not be a standalone exercise anymore, but happen as part of the overall EU ETS review.

This ‘fixes’ one of the issues that was apparent in discussions held by ERCST over the course of 2019: the MSR was often viewed in isolation (*in a way rightly so, as it was the only part of the ETS framework with an explicit review*), and seen as a ‘silver bullet’ to all sorts of ills.

Since the MSR is now not the only ‘adjustable variable’ anymore, 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.

As is presented as an option in the Commission’s public consultation for the 2030 Climate Target Plan<sup>7</sup>, one could imagine a world where the EU ETS ambition is not greatly increased, and where the EU decides that other policies will be the primary drivers to reduce emissions. In this world, the MSR intake rates would likely need to be greatly increased in order to cope with the resulting surplus on the market.

On the contrary, if we want the EU ETS to drive emission reductions, a variety of policy options can be looked at to do this, including: Increasing the target and LRF; Rebased the CAP; Introducing a price floor/corridor; Etc. A debate is then needed on what (mix of) policy option(s) is most suitable to do this, and what (residual) role the MSR is to play. For example, in a scenario where the CAP is rebased in the early 2020s, and the 2030 target and LRF are greatly increased, the MSR parameters will likely not need a similar revision as mentioned above.

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

For the first time, the EU is considering an explicit net-zero ambition, and is expected to soon enshrine this ambition into law through the European Climate Law. One could ask the question whether such an explicit

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net-zero target (*vs. the current situation where only explicit targets for the current trading period are known*) will change the mindset and behavior of market participants?

Could an explicit net-zero goal impact the investment/banking strategy of market participants? If that is the case, we could theoretically see accelerated action in the coming years, and the MSR will have to be able to cope with this.

Building on this reasoning that up till now the market dynamics might not have fully reflected the long-term market scarcity and long-term marginal abatement costs beyond 2030, we could subsequently ask the question whether a headline net-zero target for the EU is sufficient change this mindset, or whether an explicit long-term target for the EU ETS is necessary in order to come by this change.

It is important to reflect on these questions in light of the overall EU ETS review.

## **5) Evolution towards revenue maximization?**

Due to the increase in EUA prices in the last few years, auction revenues have exploded, generating over €14 billion in both 2018 and 2019 for Member States. The EU ETS has become an important source of revenues, which is especially true in times of budgetary constraints.

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. As the Commission says, 'such own resource could generate revenues for the EU budget of about EUR 10 billion, depending on the evolution of the carbon price and the extension of the system to other sectors'. Of course, the lower the 'own resources' for the EU budget are, the higher Member State contributions will have to be.

These developments could imply that 'revenue maximization' could, to some extent, become an element on the mind of policymakers during the upcoming EU ETS review. Moreover, having this motivation in mind could also lead to certain policy options becoming more attractive in the eyes of policymakers, including increasing the scope of sectors covered by the EU ETS and a possible introduction of a price floor/corridor.

It will be interesting to discuss whether this is indeed happening, and in what way this might have implications for the well-functioning of the EU ETS and the role of the MSR.