

Key issues in EU ETS review

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This paper outlines ERCST's opinion on critical topics in the ETS revision discussions ahead of the report by the rapporteur of the ENVI committee, on January 14, 2022.

Observers and stakeholders generally agree that the revision to the EU ETS needs to ensure that the transition results in a prosperous and decarbonized, but not deindustrialized Europe.

In this, it does need to consider the realities of the international framework under which the EU operates, including the results of the 2023 and 2028 stock takes that will take place under the Paris Agreement, with attention not only to the mid-century long-term decarbonization targets, but also the intermediate milestones in the 2030s.

Finally, in undertaking a review and potential revision of the EU ETS, we need to distinguish between changes in parameters (e.g. MSR thresholds) and structural changes (e.g. treatment of carbon leakage and the role of free allocation).

Market Stability Reserve

The MSR was the most important element of the EU ETS that brought credibility back into the market and saved the EU ETS. Back when it was introduced it was right to start with a simple mechanism, focus on the structural surplus ... but things have changed and there should be a proper review.

The MSR review was scheduled for 2021, but the review undertaken is in our view not systematic and not focusing on any specific key performance indicators (KPI). While not necessarily the definitive study, ERCST would like to point to the study in MSR review that it undertook in 2019 as methodical approach to the MSR review¹.

ERCST has stressed that it is of paramount importance to consider the dynamic interaction between MSR parameters and the LRF, rebasing and other overlapping EU climate policies. In this regard, maintaining the stability of the market is a key consideration i.e., a smooth price pathway allows compliance actors to plan their decarbonization efforts.

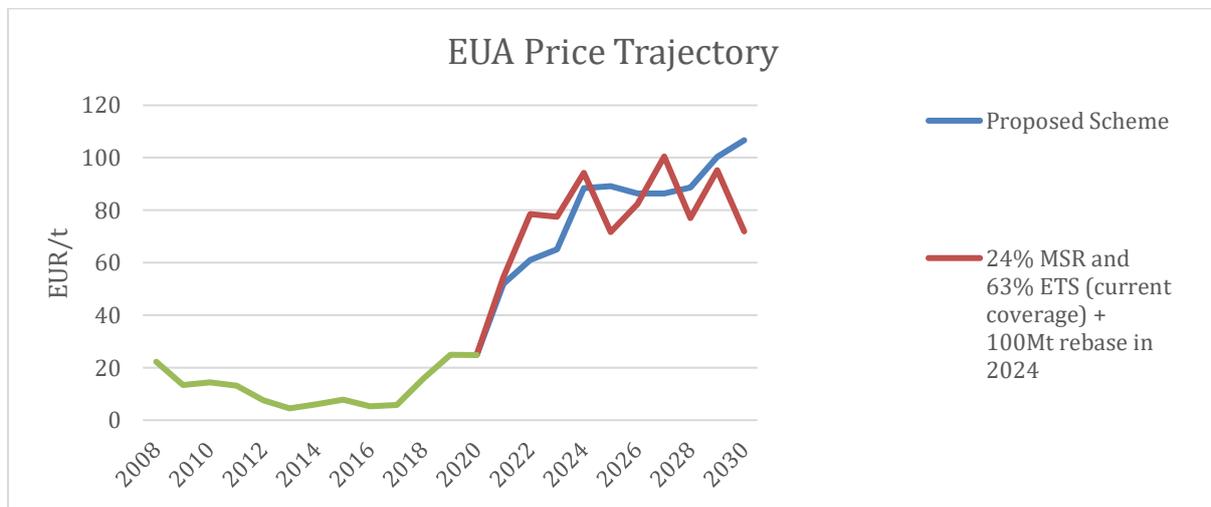
A scenario analysis conducted by ERCST and BNEF² suggests that scenarios with a higher intake rate of 24% would lead to several price spikes over the course of phase 4 – effectively compromising a smooth price trajectory and causing uncertainty in the market. In addition, the so-called threshold effect related to the intake rate of the MSR brings additional uncertainty in the market.

¹ A. Marcu, J-Y. Caneill, F. Cecchetti (2019) "Preparing the review of the Market Stability Reserve (MSR)" (Available at: <https://ercst.org/wp-content/uploads/2021/08/20191118-ERCST-Preparing-the-MSR-Review-final-paper.pdf>)

² Bloomberg & ERCST (2021): "The Review of the Market Stability Reserve (MSR)". Chapter 5. Pp.17 (Available at: <https://ercst.org/wp-content/uploads/2021/08/The-Review-of-the-Market-Stability-Reserve-MSR.pdf> (Accessed on 23 December 2021).

In the proposal, the Commission introduces a buffer intake rate to address these sources of uncertainty. This proposal is in line with a proposal made by ERCST to introduce a variable intake rate³ based on the size of the market surplus. This improves the functioning of the MSR intakes which better reflects market fundamentals if applied only to the number of allowances above a determined threshold.

Looking at the graph below, a scenario with the buffer intake rate ensures a smooth price pathway, even when the higher intake rate of 24% is maintained after 2023. However, it is important to note that in the absence of a buffer intake rate, lowering the intake rate to 12% may be preferable to avoid the price spikes associated with the high intake rate scenarios.



Source: ERCST & BNEF (2021)

In addition, ERCST supports the inclusion of aviation and maritime in the calculation of the TNAC and made the point before that this significantly improves the effectiveness and accuracy of the MSR in preserving the stability in the market.

Aviation produces a net demand for allowances, which in turn reduces actual circulation. As demand for aviation allowances is slated to increase in the next years, MSR injection may fail to reflect supply/demand conditions if TNAC keeps excluding aviation allowances. Including aviation in TNAC calculations allows for MSR intake to be more accurately based on the actual surplus on the market.

These different elements of the Commission’s proposal are important improvements to the functioning of the ETS, and in particular the MSR. On the other hand, ERCST identified

³ Variable’s intakes rates have also been discussed within the EC expert workshops on the review of the MSR: “At the expert workshops, some stakeholders saw a need for a variable intake rate to avoid large threshold effects (...)”. COM (2021) 551 final. Pp.11. Available at: https://ec.europa.eu/info/sites/default/files/revision-eu-ets_with-annex_en_0.pdf (Accessed on 23rd December 2021)

important issues in the current Directive that have not been addressed in a satisfactory manner.

In the past, ERCST has argued that the invalidation mechanism represents a significant departure from the MSR initial design and purpose – which did not include the MSR affecting the overall cap. In addition, the invalidation of allowances contributes to market uncertainty⁴.

The MSR was introduced as a long-term solution to address the ETS historical supply-demand imbalance, as well as potential future surpluses that could be resulting from future shocks. In this regard, the role of the MSR is not to bring scarcity to the market but rather to ensure that scarcity set by the cap is always expressed in the market.

The invalidation clause not only changes the nature of the MSR, but it also brings uncertainty about the level of ambition of the system – as the long-term cap will become a function of past and future market outcomes. While the proposal by the Commission makes the invalidation somewhat more predictable, ERCST contends that other instruments for setting the cap can be used, especially the LRF.

ERCST believes that the level of ambition in any carbon market should be set through the overall target and through the LRF. This approach is the most transparent for both market participants and other stakeholders and allows for a clear public debate.

ETS parameters

Changes to the ETS parameters proposed by the Commission are deemed necessary to align the contribution of ETS sectors to the increased overall 2030 ambition of the EU to reduce emissions by 55%.

Therefore, increasing the LRF to 4,2% to ensure that the decline of the cap results in emission reductions in ETS sectors of 61% by 2030 compared to 2005 should not be controversial. In addition, ERCST supports strengthening the cap through gradually increasing LRF in the spirit of addressing the effect of overlapping policies, as well as ensuring predictability for market players.

Combining an increased LRF with a one-off rebasing of the cap may seem like a solution to ensure that the increased LRF already takes effect before entering into force of the revised Directive but cannot be a blunt instrument. It needs to consider the causes that lead to the surplus.

The proposed one-off reduction of the cap could have a short-lived bullish impact on the market. On the other hand, this approach addresses the uncertainty related to the duration of the political process in a transparent manner.

Any additional rebasing must be considered carefully – considering interactions with other issues such as origin of surplus, availability of free allocation and MSR intakes. In the past,

⁴ “Another possible cause for market uncertainty is the invalidation of allowances up to the auctioning level of the previous year”. SWD (2021) 601 final. Pp 17. Available at: https://ec.europa.eu/info/sites/default/files/revision-eu-ets_with-annex_en_0.pdf (Accessed on 23 December 2021).

some have contended that rebasing of the cap is necessary to address the supply-demand imbalance and bring the cap in line with actual verified emissions. ERCST does not support that argument. Any future rebasing without analysis of the origin and the cause of the structural surplus in the EU ETS goes against the ideas of a market approach and ETS.

Not only would additional rebasing undermine the credibility of the system, but it is also misleading to associate the structural surplus with a loose market by default.

Part of the allowances in circulation are in the hands of the banking sectors and other financial players, not to trade or speculate but rather to hedge utilities and industrial actors who prefer to buy on a forward rather than spot basis. Another part of this structural surplus is held directly by industry to cover potential future deficits or as a hedge in case of price increases for compliance needs in the relevant year. Therefore, the surplus is not immediately available to market actors and immediate supply still comes mostly from auctions.

Free allocation and CBAM

The existing carbon leakage protection measures (i.e. free allocation, indirect cost compensation) have proven to be effective measures to a large extent, although in the context of much lower carbon prices.

In terms of the introduction of CBAM and phase out of free allocation in CBAM sectors, ERCST would envisage an approach that considers the international framework in which the EU, and the EU ETS, functions, at key milestones in the international climate change policy calendar, especially the two stock takes under the Paris Agreement (2023 and 2028), before considering the treatment of free allocation. For sectors outside of CBAM, free allocation should only be phased out as soon as they are included in CBAM.

Setting pre-conditions on receiving free allocation need to consider whether free allocation is a tool for preventing carbon leakage or for enabling the transition. While energy audits are a useful tool to enable the transition, implementing recommended energy efficiency related projects should not be a precondition for receiving full free allocation up to the benchmark.

Free allocation is meant to protect compliance actors from uneven climate policies, create a level-playing field and avoid carbon leakage outside the EU. Introducing preconditions based on an energy audit would undermine this role of free allocation.

ERCST recognizes that the current scope (annex 1) might disincentive decarbonization efforts as decarbonizing operations could lead to being kicked out of the ETS and loose free allocation. However, there are other solutions to address this issue including some of the other features that were proposed by the Commission such as referencing to production rather than combustion capacities.

Finally, a main concern that came up during extensive consultations with business relates to the absence of export rebates for CBAM and how that relates to free allocation for those covered by the CBAM.

ETS for road transport and buildings

In general, ERCST supports the creation of a separate ETS for road transport and buildings. Transparency is important in this period of transition and carbon pricing through the EU ETS best provides that transparency.

Instead of contributing to emission reductions in the EU, emissions in these sectors have been increasing since 1990. Carbon pricing has the potential to incentivize the uptake of low-carbon abatement options in these sectors in the most cost-efficient way. The cap of an ETS ensures that absolute emissions will go down over time.

Before implementing an ETS it is important to consider that these sectors have widely different marginal abatement cost curves than the current ETS sectors. Consequently, a separate ETS is preferred to including these two sectors into the current ETS which would be disrupted, leading to a price pathway that is not realistic for decarbonization of EU industry.

The low-price elasticity of end consumers in these sectors which enables the compliance actor to pass on the carbon cost to households that do not have the capacity to invest in low-carbon alternatives, especially low-income households that would be disproportionately affected, needs to be addressed through adequate and proportional flanking measures. It is not yet clear whether the Climate Social Fund will be sufficient to address the above concerns.

Proposing to differentiate between households and commercial entities in the new ETS could be a solution that can be justified economically and socially. However, the main concern with such an approach is the increased complexity of implementation that would create additional costs. As such, it is important to assess the feasibility of this approach.

Art 29 a

After more than 15 years of operation, the potential to trigger the provisions of Article 29a of the EU ETS, which provides for a cost containment mechanism, has now become real, with some analysts claiming that the conditions have already been fulfilled or are very close to being fulfilled.

It is becoming imperative for the good functioning of the EU ETS, given the current trend in carbon prices, but also as a matter of principle, that current vagueness in the wording, which lays out the way in which it will be operationalised, should be spelled out as part of the “Fit for 55” package.

While Article 29a has been part of the EU ETS directive for a long time, it has never been triggered. What’s more, it is still not fully understood when it will be triggered and what happens if that occurs.

Attempts at clarification were never successful and stakeholders showed little interest to pursue this line of inquiry.

Incinerators

Incinerators are currently not included in the EU ETS and it does not seem to be part of the review conversation in any significant manner. While in the past there may have been good

arguments for the exclusion of incinerators from the EU ETS, many stakeholders feel that this decision should be reconsidered.

International link for the EU ETS

After three years of hard work the rule book on Article 6 of the Paris Agreement was agreed at the Glasgow COP. The EU had in the past strongly objected to provisions in the market mechanisms under the Kyoto Protocol and has justified severing the link to international credits based on concerns regarding their environmental credibility.

The EU has practically succeeded, in the face of tough opposition, in achieving all its “asks” in the Art 6 negotiations and we now have instruments with strong environmental credentials. We also have carbon prices in the EU ETS that have moved from the 5 Euro range to the 90 Euro range.

These two elements would militate for, at a minimum, the consideration of the re-establishment of an EU ETS link with international markets under Art 6. This has not been the case so far, but in our view needs to be given very serious consideration as arguments against this link are not valid anymore.