



## CAN Europe's Position on the Market Stability Reserve

30 October 2014

*The European Commission's proposal for a Market Stability Reserve<sup>i</sup> published on 22 January 2014 aims to create more price stability in the EU Emissions Trading System (EU ETS) from 2021 onwards. Under the proposal, EU ETS allowances would automatically be put into the Market Stability Reserve when there is a large oversupply of emission allowances and released back into the market when allowances are scarcer.*

*The Market Stability Reserve is a necessary but insufficient step towards the structural reforms needed to turn the EU ETS into an effective instrument that encourages clean investments and controls emissions. Deeper reforms of the EU ETS are required, and these should be part of the legislative proposals following the European Council conclusions on the 2030 framework that were adopted in October 2014. However, this should not distract from the important task of starting a Market Stability Reserve as soon as possible so that it can help stabilise prices and send an adequate price signal.*

*The Commission's proposal on the Market Stability Reserve needs to be strengthened. It currently fails to address the immediate problem of oversupply in the EU ETS, offers no structural solution to correct this problem in the longer term, and features no limit on the amount of allowances that can be stored. This could weaken future climate targets, including the EU's 2030 emissions target, when these allowances are re-introduced onto the market. We therefore propose the following improvements to the European Commission's Market Stability Reserve proposal:*

- 1. Start the Market Stability Reserve in 2016**
- 2. Prevent back-loaded and unused allowances from re-entering the market**
- 3. Make adjustments stronger when the supply is large**
- 4. Limit the surplus from being used as future rights to pollute**

### Background

The EU's Emissions Trading Scheme (EU ETS) is the world's largest carbon market, covering more than 11,000 installations in the EU, as well as Iceland, Liechtenstein and Norway. These installations include large-scale industrial entities, such as energy companies, steel and cement producers, as well as intra-EU flights. The EU ETS sets a limit on the amount of greenhouse gas emissions that can be emitted. Companies covered by the EU ETS receive or buy emission allowances which they can trade with one another: one emission allowance allows for one tonne of CO<sub>2</sub> to be emitted. After each year, companies must surrender enough allowances to cover all of their emissions, otherwise fines are imposed. The cap is reduced over time so that total emissions decline. The ETS aims to help the EU achieve its emissions goals more cost-effectively. Moreover, the EU ETS is supposed to encourage investments in low carbon technologies.

However, a large surplus of more than 2.1 billion emissions allowances has built up in the EU ETS. This is more than all companies participating in the ETS are allowed to emit in one year. The surplus is due to lower industrial output as a result of the economic downturn, and lenient rules that allowed the use of a very large number of international carbon credits. By 2020, the EU ETS surplus will have grown to between 2.6 and 4.5 billion allowances.<sup>ii</sup> As a result of this enormous oversupply of emission allowances, the price for these rights to pollute has dropped so significantly<sup>iii</sup> that the EU ETS no longer facilitates the transition towards a renewable and energy efficient economy, and companies can delay or cancel investments in cleaner and more efficient production, risking a costly lock-in in carbon intensive infrastructure for years to come. An overhaul of the EU ETS is urgently needed to ensure that the EU ETS is in line with the EU's long-term objective of 80 to 95% emission reductions by 2050.<sup>iv</sup>

# Recommendations for an effective EU ETS Market Stability Reserve

## 1. Start the Market Stability Reserve in 2016

Under the Commission's proposal, the Market Stability Reserve would not become operational until 2021. This is too late. **In order to address the current market imbalance, the Market Stability Reserve needs to be enacted at the earliest possible date, and at the latest in mid-2016.** This would help address the growing supply and demand imbalance and could therefore help to send a clear price signal. Accordingly, **the Market Stability Reserve should then be reviewed in 2021** (and not in 2026, as currently proposed by the Commission).

## 2. Prevent back-loaded and unused allowances from re-entering the market

Close to 1.7 billion allowances could be flooding an already oversupplied market in 2019 and 2020. Not only will the 900 million back-loaded allowances return to market, but large volumes of additional allowances will also likely be released at auction in 2020. This includes any unused allowances from the New Entrants' Reserve, which still contained 424 million allowances as of July 2014.<sup>v</sup> A further 391 million allowances under the Phase 3 cap remain unaccounted for in the published free allocations and scheduled auctions.<sup>vi</sup> Presumably these are mostly allowances from installations that have partially ceased their activities, undergone significant capacity reductions, or have closed.

Current EU ETS rules specify that these additional allowances need to be auctioned<sup>vii</sup> and the current Commission proposal only attempts to smooth out the manner in which these allowances come back into the EU ETS by spreading any surge in auctions in 2020 across 2020 to 2022. According to modelling by Thomson Reuters Point Carbon,<sup>viii</sup> this will nevertheless result in a volatile carbon price, with the price remaining below 10 euros for the next couple years, before dropping to below 5 euros in 2020 and then rising steeply to around 30 euros by 2030. By contrast, the same analysis finds that a combination of permanently cancelling these allowances and an earlier start date of the Market Stability Reserve will lead to a more predictable carbon price. **As a first step, the back loaded and unused allowances should therefore be cancelled permanently. This would improve the environmental ambition of the ETS while also helping to create an adequate pollution price signal. Given that the total surplus is projected to be 2.6-4.5 billion<sup>ix</sup> by 2020, additional allowances need to be permanently removed so that the ETS can help facilitate the transition towards a renewable and energy efficient economy.**

## 3. Make adjustments stronger when the market is strongly over-supplied

The Commission proposes that when the surplus of allowances exceeds 833 million, 12% of the surplus will be transferred into the Market Stability Reserve. If the surplus falls below 400 million, 100 million allowances are released again. These thresholds are said to be based on the amount of allowances that the power sector buys in advance and stores to ensure they have enough allowances for their planned power sales. This is known as forward hedging. However, analysts disagree on the precise volume of allowances required for forward hedging.

Nonetheless, one thing that most analysts agree on is that the amount of allowances needed by the power companies for hedging will decline as the power sector becomes less carbon intensive. The Market Stability Reserve should be designed to take such a decrease into account. **The upper and lower thresholds that trigger the removal or the release of allowances should therefore decrease over time. At the same time, surplus allowances should only be re-released to the carbon market when prices have risen (Article 29a) and the surplus threshold is at the same time met. In addition, the Market Stability Reserve should set aside surplus emission allowances more rapidly than the suggested 12% of allowances in circulation annually.**

Furthermore, the response time of the Market Stability Reserve should be shortened. Under the Commission's proposal it would take two years to make corrections for any under- or oversupply. Allowances would be put in the reserve or released based on emissions data that is two years old. This time-lag could see the Market Stability Reserve reacting to obsolete information. We therefore recommend that the **Market Stability Reserve alters the auction calendar in July each year based on the previous year's surplus.**

#### 4. Limit the surplus from being used as future rights to pollute

As the proposal currently stands, allowances placed in the Market Stability Reserve would be released into the market at some point in the future. Restricting the amount of surplus allowances in the Market Stability Reserve that can be used as future rights to pollute will help ensure that the EU ETS does not cancel out the greenhouse gas reductions from other existing and future policies. If no limit is placed on the volume of allowances that can be kept in the Market Stability Reserve over time, the overachievement of the EU's current weak climate ambition will weaken climate action after 2020. **Therefore, a limit should be put on the carry-over of allowances in the Market Stability Reserve from one trading phase to the next. Furthermore, an upper limit should be set on the number of allowances that the Market Stability Reserve can hold. If the limit is reached, allowances should be cancelled instead of being transferred to the Market Stability Reserve.**

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## Necessary EU ETS reforms in the 2030 climate and energy framework

**The Market Stability Reserve would help create more stability in the EU carbon market. However, it does not solve the fundamental failings of the ETS as it currently stands. The following issues must be addressed under upcoming legislative proposals following the October 2014 European Council conclusions on the EU's 2030 climate and energy framework**

### ***Permanently addressing the surplus***

The Market Stability Reserve does not provide a permanent solution to the surplus of EU ETS allowances, which may grow to over 4 billion by 2020. It only temporarily removes allowances and returns them to the market over time. Instead, surplus allowances need to be permanently removed as they weaken future climate targets and undermine an adequate pollution price signal. Legal proposals will have to provide a permanent solution that enables cancellation of surplus allowances, in addition to the abovementioned cancellation options that should be integrated in the Market Stability Reserve.

### ***Strengthening the linear reduction factor***

In the context of ratcheting up EU's 2030 emission target ahead of the Paris summit, the ETS linear reduction factor should be increased in line with an economy-wide target of at least 55% domestic greenhouse gas reductions by 2030 – a target required to ensure the EU's fair contribution to the global effort to prevent dangerous climate change. The European Commission's proposal to increase the linear reduction factor to 2.2% after 2021 is far from sufficient to achieve that purpose.

### ***Revising the carbon leakage approach***

The EU's approach to carbon leakage needs to be significantly altered in order to support clean and competitive industries in Europe whilst at the same time avoiding overcompensation. The polluter pays principle should be respected and will need supplementing with support for additional clean and innovative industry investments. In this context, we support the establishment of an industrial innovation fund for energy intensive industries, replenished by the revenues of auctioning EU ETS allowances (comparable to the design of the existing NER300 initiative).<sup>x</sup> Increased use of auctioning of emission allowances instead of free allocations ensures simplicity and transparency and provides revenues that can support industries making the transition to low carbon solutions.

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**Climate Action Network (CAN) Europe** is Europe's largest coalition working on climate and energy issues. With over 120 member organisations in more than 25 European countries, CAN Europe works to prevent dangerous climate change and promote sustainable energy and environment policy in Europe.

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<sup>i</sup> EC(2014), COM(2014)20, (see [here](#))

<sup>ii</sup> EC (2014), SWD(2014)17, Impact Assessment accompanying the Proposal for a Decision concerning the establishment of a market stability reserve (see [here](#)) UK government: 3.1 billion, (see [here](#)); estimates by Sandbag: 4.5 billion, (see [here](#))

<sup>iii</sup> The average allowance price in 2013 was €4.47 (source : Point Carbon)

<sup>iv</sup> CAN Europe calls for a reduction of at least 95% by 2050, (see [here](#))

<sup>v</sup> [Allocation of allowances from the New Entrants' Reserve 2013 – 2020](#)

<sup>vi</sup> EU Transaction Log, European Environment Agency ETS Data Viewer

<sup>vii</sup> The requirement to auction these additional allowances is specified under Article 10(2) of the ETS Auctioning Regulations.

<sup>viii</sup> *The carbon price development when the back-loaded allowances are permanently cancelled and the Market Stability Reserve starts operating in 2017*. Source: Thomson Reuters Point Carbon, September 2014.

<sup>ix</sup> See endnote ii

<sup>x</sup> CAN Europe (2010), Horizon 2050: Steel, cement and paper (see [here](#))