

The Czech Republic under the ETS

Arguments for the introduction of an enhanced Market Stability Reserve

Introduction

The EU institutions are discussing the Commission's proposal to address the problem of the surplus of over 2 billion allowances (EUAs) that is crippling the effectiveness of the EU's Emissions Trading Scheme (ETS) – the Union's flagship instrument for climate policy.

Sandbag argues that the Czech Republic could reap advantages from backing an enhanced Market Stability Reserve (MSR). We first argue why the Czech Republic should reconsider its position on the MSR. Then we present strong ETS-based evidence, revealing the various ways in which the Czech Republic's industry is not only protected against any effects of the MSR, but can actually capitalise on these effects. We finally present more detailed information about how the proposed ETS reform would function in the concluding section of this briefing.

About Sandbag

Sandbag is a UK-based not-for-profit think tank conducting research and campaigning for environmentally effective climate policies.

Our research focus includes reform of the EU Emissions Trading Scheme, the EU 2020 and 2030 climate & energy packages, Carbon Capture Storage & Utilisation, and the phase out of old coal in Europe. The International Centre for Climate Governance ranks us in the top twenty global climate think tanks.

For more information visit our website at www.sandbag.org.uk or email us at info@sandbag.org.uk

The Czech Position

Sandbag welcomes Prague's support for the introduction of the MSR. It is also especially appreciative of the Czech Republic's willingness to prevent the supply shock that would befall the ETS if the 900 Mt of EUAs from the backloading decision were allowed to return onto the carbon market. Nevertheless, all this effort is still jeopardized by the fast pace at which the surplus is already growing, and also by the additional supply-side shock posed by the forcible auctioning in 2020 of EUAs that failed to be allocated during Phase 3. Therefore, **Sandbag would earnestly entreat the Czech authorities to consider the evidence presented in this briefing, and to publicly call for the introduction of the MSR at a date significantly earlier than 2021, and for the unallocated EUAs to be placed into the reserve together with backloaded ones.**

Such an MSR reform would not only improve the functioning of the ETS, but is also in line with the Czech Republic's economic interest, and by no means imposes a threat on Czech economic growth. First, it would increase the value of the allowances held by Czech companies, who could then sell them at a higher value, while the Czech government would stand to gain additional revenues from EUA auctions, which could be used to boost investment in the low-carbon economy and to defray costs associated with a higher carbon price. Second, due to safeguards already in place, Czech consumers, as well as Czech companies' competitiveness, are well protected against any minor negative effect that the rise in the carbon price may trigger for energy bills. **Countries where cumulative over-supply relative to cumulative emissions is at levels comparable to those in the Czech Republic (23% over the 2008-2003 period), such as Ireland (23%) and Luxembourg (26%), have realised this already and support an enhanced MSR.** Finally, in exchange for its support for an enhanced MSR, Prague might consider requesting that the way in which the MSR operates be tailored to reflect the circumstances of individual Member States.

The evidence supporting an enhanced MSR

Sandbag would like to present you with strong evidence showing the different ways in which Czech Republic's biggest emitting sectors can capitalise on the introduction of the enhanced MSR, as well as how they are well protected against any additional costs for years to come.

- Over the 2008-2013 period, **the Czech Republic has received 24% more EUAs than its emissions, protecting it well against any increases in the carbon price in the foreseeable future.** An enhanced MSR mechanism would increase CO₂ prices and contribute to the raise of revenues for oversupplied countries, as well as increase the value of EUAs held as assets by over-allocated companies. According to estimates by PointCarbon¹, **the Czech treasury would receive an extra EUR 657 million over the 2015-2025 period if, instead of merely placing the backloaded allowances into the MSR, Member States also agreed to a 2019 start and placed the unallocated allowances as well into the reserve.**

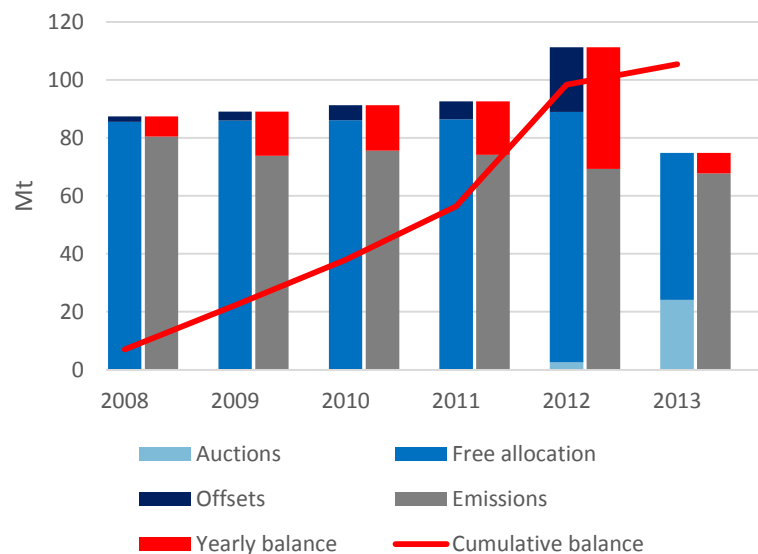


Figure 1: The balance between supply and demand in the ETS for the Czech Republic (2008-2013). Source: EUTL & Sandbag calculations.

- The biggest direct contributor to the expansion of Czech emissions surplus is the emissions reduction in its power sector.** Total emissions in the Czech Republic have decreased by 16%, from more than 80 Mt in 2008 to 68 Mt in 2013. The overall emissions reduction of the power sector for the period 2008-2013 was about 7.6 Mt (more than 13% below 2008 levels) **and accounted for 74% of the total emissions reductions. The decrease in power sector emissions is caused by the expansion of zero-carbon sources and the contraction of fossil fuel generation** – even while overall power generation increased by nearly 4% over 2008-2013 (from 77 TWh to 80 TWh). Fossil fuels have decreased 8% overall over this period, driven by falling lignite (more than -15%) and hard coal (more than -14%), and by increasing gas (nearly +53%). The significant expansion of nuclear (nearly +16%), hydro power (nearly +57%) and renewables (from 0 to over 3% of all electricity generation), acted as an additional powerful factor in decreasing emissions. **This shows unequivocally that Czech Republic can continue to curb emissions substantially while circumventing direct influences on the competitiveness of its industry.**
- Only relatively a small part of the Czech Republic's massive surplus proceeds from the reductions in emissions in manufacturing sector.** For the manufacturing sector the reduction was about 5 Mt (nearly 23% below 2008 levels). The reductions of the three largest manufacturing sectors for the analysed period (2008-2013) has been of 29% for the cement and lime sector (who alone constitutes 72% of the emissions abatement in industry), 25% for the mineral oil sector, and 2% for the iron and steel sector. The overall

number of installations in these three sectors remained the same, with installation closures occurring only in the ceramics and pulp and paper sectors, whose emissions constitute a very small proportion of the overall decrease. **Therefore, decarbonisation of Czech economy and the surplus the country acquired were hardly at the cost of the Czech manufacturing sector.**

- **The three Czech manufacturing sectors with the largest emissions in 2013 possess very large surpluses of the accumulated EUAs and are well protected from the effects of the carbon price.** These sectors are iron and steel sector (3.1 Mt, or 38% of manufacturing emissions); cement and lime (2.9 Mt, or 35%); and mineral oil (0.8 Mt, or 10%). Iron and steel is the sector expected to have the longest lasting surplus, until 2040,ⁱⁱ while the dates are 2036 for the cement and lime sector and 2034 for the mineral oil.ⁱⁱⁱ
- **Therefore, leaving the combustion sector aside^{iv}, the Czech industrial companies in aggregate are unlikely to be in need to purchase any allowances or offsets in the next few decades.** The Czech's industrial surplus will actually keep increasing for one more decade and will not be exhausted until the late 2030s. Therefore, Czech industrial companies in aggregate are unlikely to be in need to purchase any allowances or offsets before that date. What is more, they will be in **a competitive advantage relative to other countries whose surplus will be exhausted much earlier**, such as Germany (2030). In fact, many countries supportive of an enhanced MSR will exhaust their industrial surplus before the Czechs do, such as France (2029), the Netherlands (2028) or Portugal (2028).
- Finally, the industrial companies can **capitalise on the allowances they already have**. First, the MSR does not act on freely allocated allowances, so **its introduction cannot take away the** abovementioned protection from Czech industrial installations. Second, by raising the carbon price, an enhanced MSR would not only prop up companies' balance sheets through the distribution of additional assets, but also act as **a source of revenue in the current economic situation for over-allocated companies**.

Sandbag recommendations for MSR reform

The inability of the European carbon market to correct supply and demand imbalances is a fundamental design flaw, and creating an automatic mechanism to do this, both in situations of shortage and of over-supply, would create a more stable and predictable environment for businesses to thrive and Europe to decarbonise. The proposed measure, a Market Stability Reserve (MSR), would introduce a transparent, predictable and non-discretionary mechanism to reduce the huge and growing over-supply. By automatically adjusting supply by altering on EUA auction volumes, imbalances are avoided in the future – both during oversupply and shortage situations.

Unfortunately, even using the Commission's own conservative surplus forecast, their original MSR proposal allows the surplus to rise up to 2.2 billion tonnes by 2020 – a new peak relative to the present situation. Moreover, the surplus will not increase gently, but is instead expected to develop chaotically due to a series of massive supply-side shocks that are set to occur over the next five years, as is shown in red in Figure 2. When the market experience such constant ups-and-downs, companies under the ETS have no reliable policy framework guiding their investment decisions consistently towards decarbonisation, which is why this “rollercoaster effect” must be avoided at all costs.

In order for correct for this, Sandbag brings the following three proposals for enhancing the Commission's proposal on the Market Stability Reserve, based on analysis of the ETS data:

1. **Launch the MSR without delay in 2016;**
2. **Prevent the backloaded allowances from returning to the market;**
3. **Prevent the unallocated allowances from returning to the market.**

The first supply-side shock is due to the “backloading” decision, which postponed the auctioning of 900 million EUAs that were slated for auctioning at the beginning of Phase 3 (2013-2020) until the last two years of the same phase. That decision was taken in 2013 in order to postpone the crash that the glut of EUAs would have otherwise caused at the beginning of the phase. Obviously, postponing the auction only postpones this crash, which is why the Council, Parliament and Commission are currently discussing the placement of these 900 million EUAs directly into the reserve as a permanent solution for this problem.

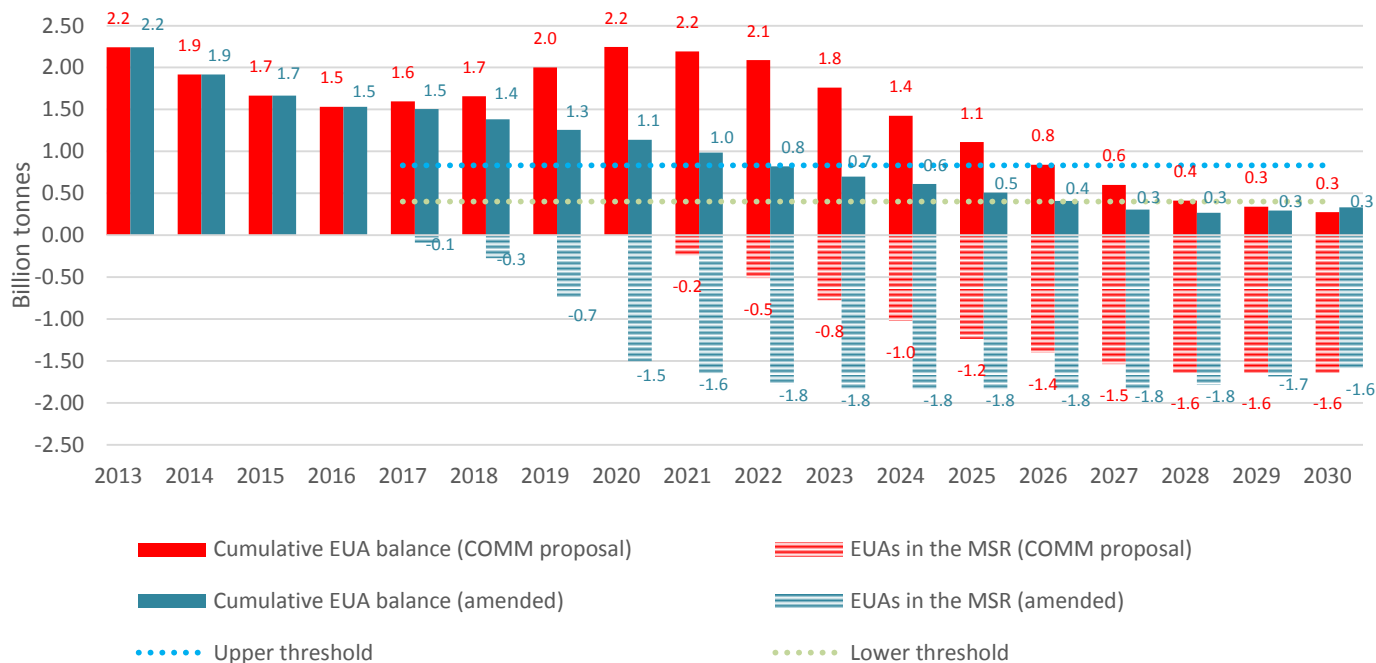


Figure 2: The carbon market effect of an early start and placing the backload into the MSR

The second shock is due to the simultaneous release by means of auctioning of a large volume of allowances that had originally been meant for free allocation, but, for one of two possible reasons, were not actually allocated during Phase 3. The first possible source of unallocated allowances is the New Entrants’ Reserve, which contains a large volume of EUAs meant for allocation to installations that were not previously covered by the ETS (e.g. newly established companies, new production lines, newly regulated production processes, etc.) but that might potentially materialise at some point. The second source of unallocated allowances is made up of EUAs withheld from installations whose production has fallen by 50% or more. According to the ETS Directive, allowances for both sources must be auctioned in the last year of the phase, i.e. 2020. Sandbag estimates that the total volume of unallocated allowances would be 754 Mt. The sudden release of these EUAs must be avoided, as well, since it would have the same destabilising effect on the market as the release of the backloaded EUAs would.

Finally, Sandbag, akin to the government of the United Kingdom, has reservations about the accuracy of the Commission’s forecast. The surplus expected by the Commission, of around 2.6 billion tonnes without an MSR, is strongly influenced by expectations for electricity consumption over the next five years. Contrary to the Commission, which expects electricity consumption to rise, Sandbag believes that the falling trend in electricity consumption will continue, giving rise to a 4.4 billion tonne surplus by 2020.v (The British government forecasts a surplus of nearly 3.1 billion tonnes for the same year.) In order to restrain the unbridled rise of this surplus, and thereby restore the credibility of the ETS as an effective instrument of European climate policy, the MSR must start much earlier.

Endnotes

ⁱ This value is based on an update requested by Sandbag to PointCarbon's projections from February 27, 2015, which had contrasted the expected impact of an MSR designed according to the outcome of the ENVI vote against the expected impact of the MSR as proposed by the Commission. The difference between the revenue impact of the ENVI MSR and that of the Commission MSR was estimated at 1.5 billion tonnes. A large part of this has already been secured by the Czech Republic when it agreed to transfer the backloaded allowances into the reserve.

ⁱⁱ This date is likely subject to change once waste gas transfers are factored in for the iron & steel and pulp & paper sectors. This is because some industrial installations transfer waste gases to combustion installations together with a corresponding amount of freely allocated allowances. Such allowance transfers can occur within companies or between companies and hence may reduce companies' overall allowance balances. Unfortunately, the EU transaction log currently does not provide data on waste gas transfers. Sandbag has been able to collect some data on allowance transfers from specific companies and industry bodies. However, without a complete data set it is not possible to calculate precise balances split by country, sector and company. Sandbag strongly urges the European Commission to change the reporting rules for these transfers, so that this data is consistently collected and also transparently made available through the EU Transaction Log.

ⁱⁱⁱ Non-electricity generating installations from the combustion sector did have in 2013 emissions larger than any of the other 3 sectors (9 Mt). 34% of that are emissions from just two installations belonging to petrochemical group Unipetrol, while a further 30% are due to a single installation belonging to steel-maker ArcelorMittal. The entire non-power combustion sector has a surplus estimated to run until 2028.

^{iv} 85% of the combustion sector's emissions since 2008 were due to electricity generation. If one treated non-power installations in the combustion sector (the same installations mentioned under endnote iii) also as part of industry, industrial emissions have fallen by 5 Mt (23%) during 2008-2013. Under this reclassification, this residual combustion sector would have accounted for nearly 3.5 Mt of emissions cuts (nearly 68% of the reclassified industry) – with all other industrial sectors accounting for much less of the contraction or actually growing. This tremendous contribution of the non-power combustion sector however is due to a single Ostrava installation belonging to ArcelorMittal, whose emissions contracted by 3.7 Mt. (It is possible for the installation to contract more than the entire non-power combustion sector because other installations actually experienced a growth of emissions.)

^v [The Eternal Surplus of the Spineless Market, March 2015.](#)

Full information on Sandbag and our funding is available on our website (www.sandbag.org.uk).

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