

Summary

This briefing contains Sandbag's consolidated amendments to the Commission's legislative proposal for a Market Stability Reserve (MSR).

The Commission proposal, as it currently stands, fails to bring the oversupply of allowances on the market within the Commission's desired threshold until 2027. As we show, such a delay will destabilise the European carbon market further, and leave the market unable to drive cost effective emission cuts planned for the 2030 climate and energy agreement.

It should further be noted that the Commission uses now obsolete projections for energy consumption and market evolution in the coming years. Under Sandbag projections, using current data, the Emissions Trading Scheme looks to remain an irrelevance for even longer, despite the Commission's proposal.¹

Sandbag supports four key changes to improve this proposal. They are:

- Cancel backloaded allowances
- Cancel unallocated free allowances
- Start the MSR in 2017
- Calibrate the annual adjustments

Individual briefings for each of these four recommendations, arguing in more detail why each is needed and what specific legal amendments are required to implement them are available on request and we are happy to have one-to-one meetings to discuss these proposals, and variations on these proposals, in more detail. In this briefing we defend our recommendations collectively and show how they would be integrated together into a complete set of consolidated amendments.

About Sandbag

Sandbag is a UK-based not-for-profit thinktank 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, and the persistence of old coal in Europe. The International Centre for Climate Governance ranks us in the top twenty global climate think tanks.

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¹ Sandbag 2020 surplus projection (October 2014) http://www.sandbag.org.uk/site_media/pdfs/reports/Briefing-2020surplusprojection.pdf

RATIONALE FOR THESE CHANGES

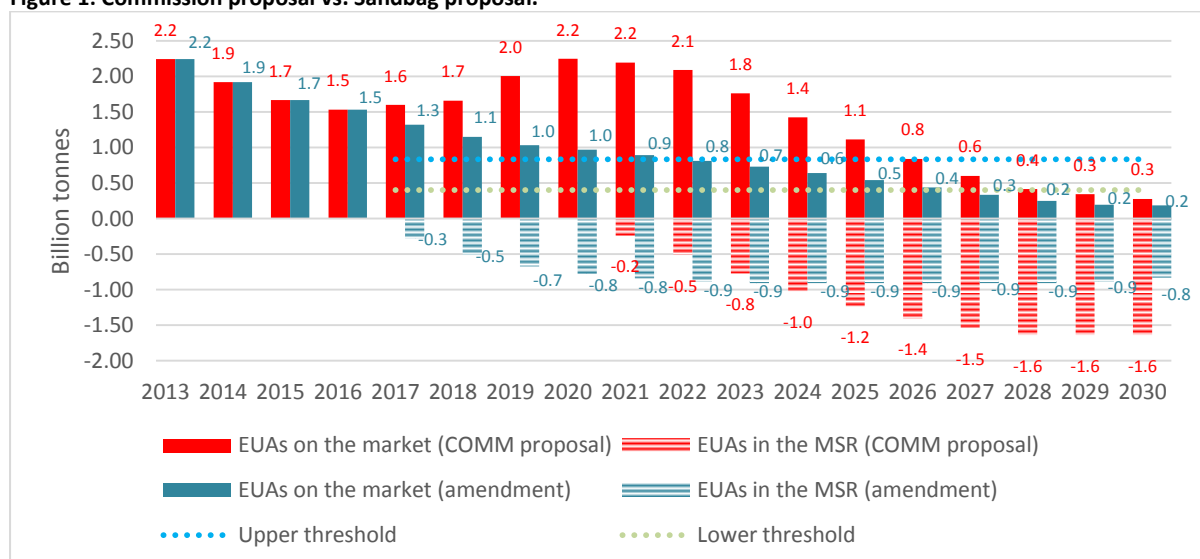
Given that the Market Stability Reserve is intended to address the current oversupply of allowances in the EU Emissions Trading Scheme, it makes little sense to delay the implementation of the mechanism until 2021, when it could realistically start as early as 2017.

Any delay will needlessly allow the surplus to grow very much larger before the Market Stability Reserve can take effect, meaning it will take longer to start rallying the carbon price, and longer to get supply down to proposed levels (400-833 million). This is particularly true if 900 million backloaded allowances are allowed to re-enter the market in 2019 and 2020, along with any unused allowances from the New Entrant's Reserve, from rules governing partial closures and other sources (which currently account for approximately 800 million more allowances).²

If these allowances are allowed to re-enter the market in 2019 and 2020, we can expect another price crash as supply floods demand in those years. This will needlessly destabilise the market and expectation of the coming crash will delay investment and exacerbate carbon lock-in. Rather than allowing these allowances to re-enter the market we propose cancelling them. This would begin to re-align the EU ETS with the cost-effective trajectory to 2050 in the Commission's Low Carbon Roadmap.

Finally, we propose changing the annual supply adjustments made by the Market Stability Reserve so that they are more sensitive to market conditions. We would see the MSR make larger adjustments when supply is further from the target supply range of 400-833 million, but attenuate adjustments as supply nears these thresholds. This helps to correct for extreme situations more rapidly, but also guards against the danger that the thresholds are set at the wrong levels to accommodate forward hedging needs.

Figure 1: Commission proposal vs. Sandbag proposal.



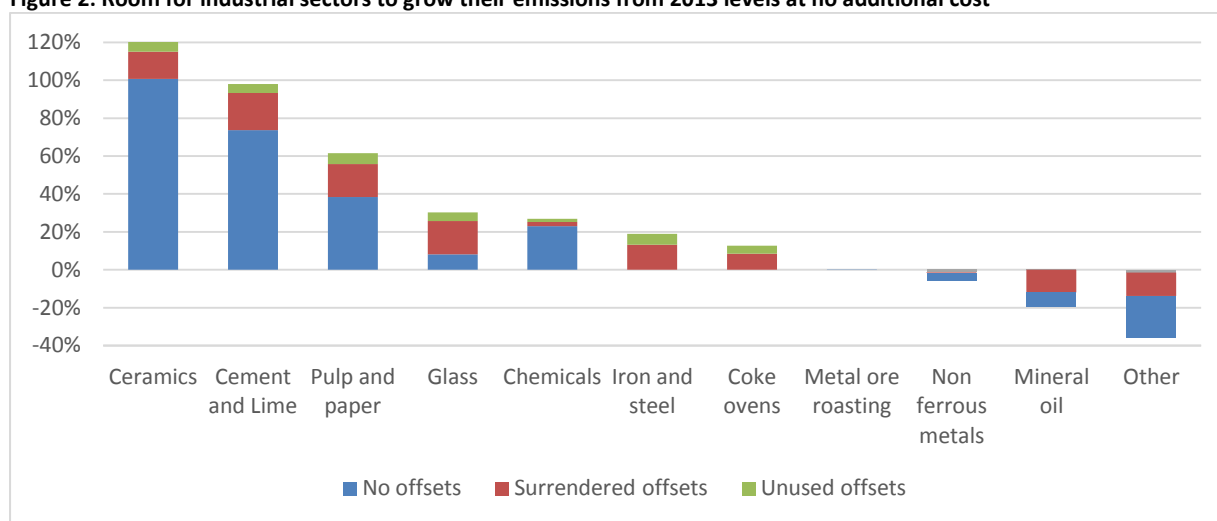
Source: European Commission, Sandbag calculations

² At the time of writing the New Entrant's Reserve still contains some 424 million allowances, and a further 391 million allowances remain unaccounted for in the published free allocations and scheduled auctions for this trading period. EU Transaction Log, DG Clima website and European Environment Agency ETS Data Viewer (accessed July 2014).

By our calculations, the Commission proposal as it stands will take until at least 2027 to get supply within this range, using the Commission’s Reference scenario. If the annual adjustments under the Market Stability Reserve were initiated from 2017, the backload and other unused allowances were cancelled, and annual adjustments were re-calibrated, the surplus could be brought within the Commission’s proposed thresholds by 2022 – 5 years earlier.³

Industry has expressed some concerns that withholding allowances from Phase 3 auctions will create regulatory uncertainty and increase their exposure to carbon leakage. However, our research finds most industrial sectors have received enough free allowances to significantly grow their emissions between now and 2020 without incurring any carbon costs. This derives from a combination of factors including the exaggerated coverage of the carbon leakage list, weak efficiency benchmarks and reduced activity levels against relatively fixed free allocations.

Figure 2: Room for industrial sectors to grow their emissions from 2013 levels at no additional cost⁴



Source: EU Transaction Log, Sandbag calculations

While a small minority of industrial sectors and industrial companies can expect to face some carbon costs by 2020, we note that this was supposed to be the rule rather than the exception, and that only the most carbon efficient performers in the most leakage exposed sectors were supposed to receive all the allowances they needed. We recommend that following the agreement of the EU 2030 package on climate and energy, more should be done to incentivise industrial transition to a low carbon future through the introduction of investment incentives. This should be addressed in legislative proposals that will follow in due course and should not be a reason to prevent or water down the introduction of an effective MSR.

These changes would require the following 10 amendments to the Commission proposal:

³ In fact, this state may arrive earlier. The dataset used in **Figure 1** is provided by the Commission, which assumes that no unused allowances will exist – in spite of the small likelihood that the new entrants reserve be exhausted and the high likelihood that installation closure and partial cessation of activities raise the volume of unused allowances. The volume of EUAs on the market would therefore be smaller in 2020 (and the volume of EUAs in the MSR accordingly higher), thereby bringing closer the date when the market is within its stable boundaries.

⁴ Emissions change relative to verified emissions 2013 levels (EUTL), assuming linear growth or decline.

CONSOLIDATED AMENDMENTS:
(In order of appearance in the original proposal)

Amendment 1: Early establishment of the MSR and calibration of annual supply adjustments

Proposal for a decision - Recital 2

Justification - If the current glut of allowances is seen to be a problem, it makes little sense to wait until 2021 to start to address it. We see January 2017 as the earliest practical stage that the Market Stability Reserve could be implemented.

Moreover, the Commission’s proposed adjustments potentially take a very long time to reach the target supply range (400-833m). They also risk removing allowances from auction when they are needed and returning them when they are not, if it turns out that these thresholds have not been set at the appropriate level to accommodate forward hedging needs for companies policed by the scheme. We therefore recommend including a more calibrated adjustment, which removes more allowances when the supply of allowances is very far from the thresholds, but attenuates as the supply approaches the thresholds.

Text proposed by Commission	Amendment
(2)[...]In order to address this problem and to make the European Emission Trading System more resilient to imbalances, a Market Stability Reserve should be established. To ensure regulatory certainty as regards auction supply in phase 3 and allow for some lead-time adjusting to the introduction of the design change, the Market Stability Reserve should be established as of phase 4 starting in 2021. In order to preserve a maximum degree of predictability, clear rules should be set for placing allowances into the reserve and releasing them from the reserve. Where the conditions are met, beginning in 2021 , allowances corresponding to 12% of the number of allowances in circulation in year x-2 should be put into the reserve. A corresponding number of allowances should be released from the reserve when the total number of allowances in circulation is lower than 400 million.	(2)[...] In order to address this problem and to make the European Emission Trading System more resilient to imbalances, a Market Stability Reserve should be established on 1 January 2017 . In order to preserve a maximum degree of predictability, clear rules should be set for placing allowances into the reserve and releasing them from the reserve. Where the conditions are met, beginning in 2017 , allowances corresponding to 33% of the difference between the 833 million and the number of allowances in circulation in year x-2 should be put into the reserve. A corresponding number of allowances should be released from the reserve when the total number of allowances in circulation is lower than 400 million.

Amendment 2: Cancel unallocated free allowances at the end of each trading period

Proposal for a decision - Recital 3

Justification - Separate to introducing a Market Stability Reserve the Commission’s proposal also introduces a separate mechanism to shift two thirds of any excess allowances (e.g. from the backload and from unallocated sources) auctioned in the final year of each trading phase into the first two years of the subsequent phase as a means of smoothing out the supply across the phases.

Such a mechanism does little to prevent these returning allowances from flooding the market at the end of Phase 3, weakening the carbon price and hindering the efficacy of the market stability reserve. Instead, we propose cancelling these allowances. This will also help to realign the ETS cap with the cost-effective trajectory to 2050 implied by the Low Carbon Roadmap. Sandbag’s calculations find that 2.6 billion allowances need to be removed from the ETS between now and

2030 in order to re-align the ETS with the Roadmap milestones.⁵ The extent of the surpluses that are continuing to accrue in the market is such that removing this volume of allowances is the minimum that is required to restore balance to the market.⁶

Text proposed by Commission	Amendment
(3) Furthermore, in addition to the establishment of the Market Stability Reserve, a few consequential amendments should be made to Directive 2003/87/EC to ensure consistency and smooth operation of the ETS. In particular, the operation of Directive 2003/87/EC may lead to large volumes of allowances to be auctioned at the end of each trading period which can undermine market stability. Accordingly, in order to avoid an imbalanced market situation of supply of allowances at the end of one trading period and the beginning of the next with possibly disruptive effects for the market, provision should be made for the auctioning of part of any large increase of supply at the end of one trading period in the first two years of the next period .	(3) Furthermore, in addition to the establishment of the Market Stability Reserve, a few consequential amendments should be made to Directive 2003/87/EC to ensure consistency and smooth operation of the ETS. In particular, the operation of Directive 2003/87/EC may lead to large volumes of allowances to be auctioned at the end of each trading period which can undermine market stability. Accordingly, in order to avoid an imbalanced market situation of supply of allowances with possibly disruptive effects for the market, provision should be made for canceling any large increase of supply at the end of phase 3 .

Amendment 3: Early start

Proposal for a decision: Article 1 – paragraph 1

Justification - If the current glut of allowances is seen to be a problem, it makes little sense to wait until 2021 to start to address it. We see January 2017 as the earliest practical stage that the Market Stability Reserve could be implemented.

Text proposed by Commission	Amendment
1. A Market Stability Reserve is established, and shall operate from 1 January 2021 .	1. A Market Stability Reserve is established, and shall operate from 1 January 2017 .

Amendment 4: Early provision of information

Proposal for a decision: Article 1 – paragraph

Justification- For annual adjustments to commence in January 2017, as proposed in Amendment 1 and 2 above, it will be necessary to know the total allowances in 2015 (year x-2). The first opportunity to publish this will be May 2016, after the compliance 2015 compliance data is published.

Text proposed by Commission	Amendment
2. The Commission shall publish the total number of allowances in circulation each year, by 15 May of the subsequent year. [...] The first publication shall take place by 15 May 2017 .	2. The Commission shall publish the total number of allowances in circulation each year, by 15 May of the subsequent year. [...] The first publication shall take place by 15 May 2016 .

Amendment 5: Better calibration of MSR volumes subtracted from the market

Proposal for a decision: Article 1 – paragraph 3

⁵ The Low Carbon Roadmap implied domestic emissions cuts 25% below 1990 levels by 2020 and 40% in 2030. We calculate that a lower 2020 target, would imply cuts of 1.4 billion in Phase 3 and 1.2 billion between 2021 and 2030. See http://www.sandbag.org.uk/site_media/pdfs/reports/Sandbag-ETS2014-SlayingTheDragon.pdf

⁶ By 2020 the Commission estimates that 2.6 billion could accrue in the scheme. The UK government estimates 3.1 billion will accrue by then and Sandbag estimates 4.5 billion.

Justification- The Commission’s proposed adjustments potentially take a very long time to reach the target supply range (400-833m) and risks removing allowances from auction when they are needed and returning them when they are not. We therefore recommend including a more calibrated adjustment which removes more allowances when the supply of allowances is very far from the thresholds, but attenuates as supply approaches the thresholds.

Text proposed by Commission	Amendment
3. In each year beginning in 2021 , a number of allowances equal to 12% of the total number of allowances in circulation in <u>year</u> x-2, as published in May year x-1, shall be placed in the reserve, unless this number of allowances to be placed in the reserve would be less than 100 million .	3. In each year beginning in 2017 , a number of allowances equal to 33% of the difference between 833 million allowances and the total number of allowances in circulation in year x-2, as published in May year x-1, shall be placed in the reserve, unless this number of allowances to be placed in the reserve would be below zero .

Amendment 6: Better calibration of MSR volumes added to the market

Proposal for a decision: Article 1 – paragraph 4

Text proposed by Commission	Amendment
4. In any year, if the total number of allowances in circulation is lower than 400 million, 100 million allowances shall be released from the reserve. In case less than 100 million allowances are in the reserve, all allowances in the reserve shall be released under this paragraph.	4. In any year, if the total number of allowances in circulation is lower than 400 million, 33% of the difference between 400 million allowances and the number of allowances in circulation shall be released from the reserve. In case less than this volume of allowances are in the reserve, all allowances in the reserve shall be released under this paragraph.

Amendment 7: Early Start and explicit provision for cancelling allowances

Proposal for a decision

Article 2 – paragraph 2

Directive 2003/87/EC

Article 10 – paragraph 1

Justification - If the current glut of allowances is seen to be a problem, it makes little sense to wait until 2021 to start to address it. We see January 2017 as the earliest practical stage that the Market Stability Reserve could be implemented. This in turn requires that the annual report on the total allowances in circulation be published by May 2016, which requires political agreement to be reached before then. We also feel it is important to clarify that auctions need to be adjusted for any allowances cancelled, and also to establish a clearer provision for Member States to voluntarily cancel allowances from their national auctioning entitlement if they so choose.

Text proposed by Commission	Amendment
“1. From 2021 onwards, Member States shall auction all allowances that are not allocated free of charge in accordance with Article 10a and 10c and are not placed in the Market Stability Reserve established by Decision [OPEU please insert number of. this Decision when known] of the European Parliament and of the Council(*).”	“1. From 2017 onwards, Member States shall auction all allowances that are not allocated free of charge in accordance with Article 10a and 10c, are not placed in the Market Stability Reserve established by Decision [OPEU please insert number of this Decision when known] of the European Parliament and of the Council(*) and are not cancelled by Member States or market participants. ”

Amendment 8: Removing the Commission’s proposed fix for unused free allowances

Proposal for a decision: Article 2 – paragraph 3 (deleted)

Directive 2003/87/EC

Article 10 – paragraph 1a (new)

Justification – In addition to the Market Stability Reserve, the Commission proposal introduces a separate mechanism to adjust auction supply that shifts excess auction volumes from the final year of each phase into the first two years of the following phase. This mechanism mainly addresses the influx of unassigned free allowances that are auctioned in the final year of each phase.

It seems inelegant and unnecessary to introduce two separate and competing mechanisms to the EU Emissions Trading Scheme to maintain market stability and to regulate supply.

We propose removing this second mechanism and instead, address this influx of unassigned allowances at the end of each phase by cancelling them (see Amendment 9).

Text proposed by Commission	Amendment
<p>3. In Article 10, the following paragraph shall be inserted:</p> <p><i>“1a. Where the volume of allowances to be auctioned by Member States in the last year of each period referred to in Article 13(1) exceeds by more than 30% the expected average auction volume for the first two years of the following period before application of Article 1(3) of Decision [OPEU please insert number of this Decision when known], two-thirds of the difference between the volumes shall be deducted from auction volumes in the last year of the period and added in equal instalments to the volumes to be auctioned by Member States in the first two years of the following period.”</i></p>	<p>[Deleted]</p>

Amendment 9: Cancel backloaded allowances and unallocated allowances

Proposal for a decision: Article 2a(new)

Justification- 900 million allowances “backloaded” from auction in years 2014-2016 are due to re-enter the market in 2019 and 2020, as agreed under Commission Regulation (EU) No 176/2014. Even if the Market Stability Reserve starts making annual adjustments from 2017 as we propose, this influx of allowances will overwhelm it, aggressively increasing supply when the Market Stability Reserve is attempting to reduce it. We propose instead, that these should be withheld from the market and cancelled.

In addition to the 900 million backloaded allowances due to re-enter the market in 2019 and 2020, large volumes of unallocated free allowances also threaten to flood the market in 2020, disrupting the supply regulation of the Market Stability Reserve. These include unused allowances left in the New Entrant's Reserve, as well as free allowances withheld under rules governing partial cessations, significant capacity reductions or closures. As of July 2014, these together account for approximately 800 million allowances above and beyond the backloaded volumes.⁷

The Commission's proposal to smooth out the auction trajectory between 2020 and 2021/22 (Article 2) is a compromise in case of political obstacles to intervening in supply before 2021. A more direct approach to the problem is simpler and more effective.

We propose that these unallocated allowances should be cancelled, noting that the current trajectory of the cap remains misaligned with the cost-effective trajectory defined by the Low Carbon Roadmap. We propose a new Article be introduced to the Commission proposal to achieve this.

Text proposed by Commission	Amendment
	<p style="text-align: center;">Article 2a <i>Cancellation of backloaded allowances and unallocated allowances</i></p> <p><i>1. In 2019, 300 million allowances that were scheduled for auction under Commission decision 176/2014 shall instead be cancelled. In 2020, 600 million allowances that were scheduled for auction under Commission decision 176/2014 shall instead be cancelled.</i></p> <p><i>2. At the end of phase 3, any allowances remaining in the new entrants' reserve and any allowances not allocated due to partial cessations, closures or significant capacity reductions shall be considered "unallocated allowances". A volume of allowances equivalent to the total number of unallocated allowances shall be withdrawn from auction in 2020 and cancelled.</i></p>

Amendment 10: Early Review

Proposal for a decision: Article 3

Justification - If the annual adjustments under the Market Stability Reserve are initiated earlier, it also makes sense to bring forward the date of the first review. If the Market Stability Reserve starts in 2017 as we recommend, we feel that four years of operation is a suitable length before the first review is conducted by 31 December 2020, and this also aligns neatly with the end of Phase 3.

Text proposed by Commission	Amendment
By 31 December 2026 , the Commission shall on the basis of an analysis of the orderly functioning of the European carbon market review the Market Stability Reserve and submit a proposal, where appropriate, to the European Parliament and to the Council.	By 31 December 2020 , the Commission shall on the basis of an analysis of the orderly functioning of the European carbon market review the Market Stability Reserve and submit a proposal, where appropriate, to the European Parliament and to the Council.

⁷ At the time of writing the New Entrant's Reserve still contains some 424 million allowances, and a further 391 million allowances remain unaccounted for in the published free allocations and scheduled auctions for this trading period.