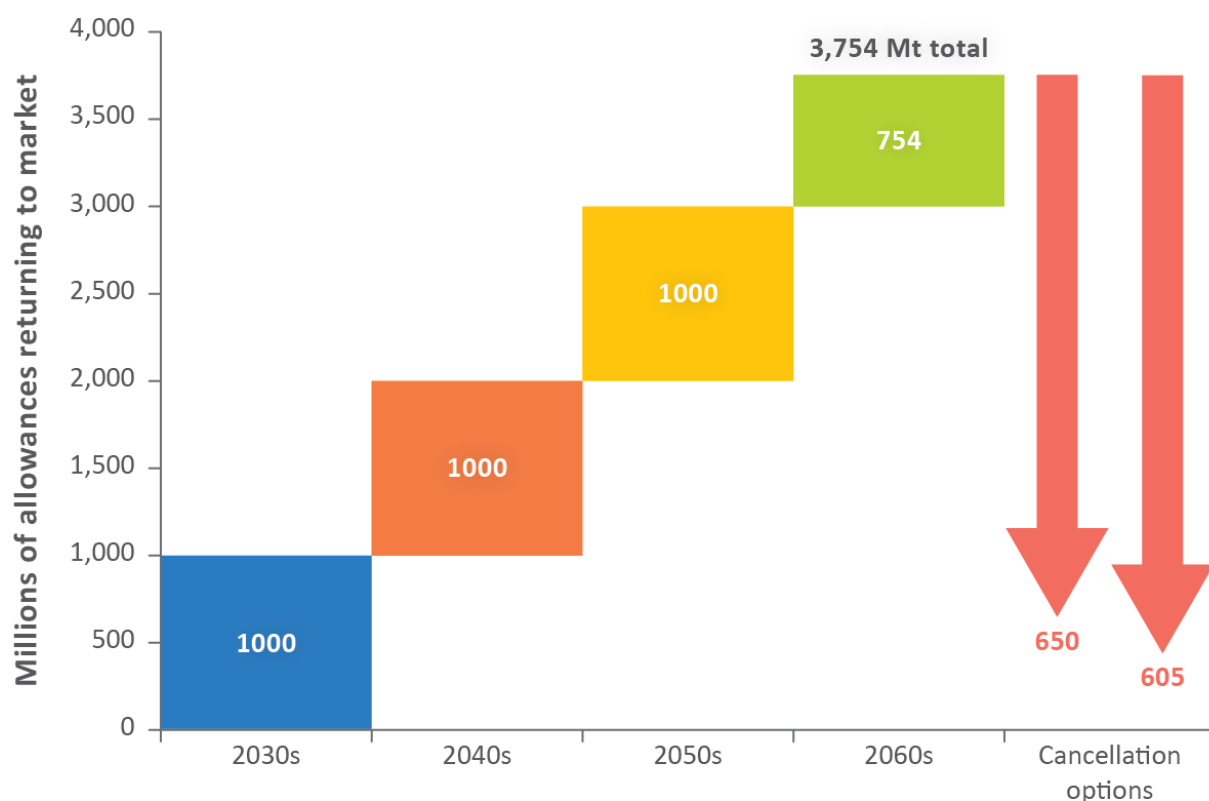


A tale of two surpluses

MSR cancellation options for Phase 4



There is little difference between the two proposed cancellation options (a fixed limit of 650Mt or a limit of the previous year's auctioning volumes). The graph shows allowances contained in the Market Stability Reserve in 2030 by decade of their expected return to the market, alongside the two main proposed cancellation options. (Using Sandbag's base emissions scenario)

Key analytical conclusions

A combination of elements from the European Parliament and Council ETS positions, if maintained in dialogues, would leave the Emissions Trading System in better shape - though still with further to go to guarantee cost-effective emissions reductions.

- **The persistent surplus in the EU ETS is composed of two main elements – the surplus available to the market and surplus which has not yet been released.** The bulk of the latter will be transferred to the MSR from 2019.
- The two elements of the surplus affect the price signal generated by the system in different ways, therefore any changes to the rules will lead to different price impacts.
- **The Council position on annual cancellation from the Market Stability Reserve (MSR) is a particularly positive proposal**, especially combined with doubling the MSR withdrawal rate. These changes would initially increase the speed with which the MSR takes allowances from the market during Phase 4 (up to 2030), supporting an increased carbon price. Under base emissions the reform theoretically removes the surplus on the market by the early 2030s, but in reality this outcome isn't certain; it will depend on the level of actual emissions.
- However, these changes are only part of the solution. With a current surplus in circulation of 1.7 billion tonnes in the EU ETS, **we still forecast a surplus available to the market of over 1 billion tonnes in 2025.** And in a “low emissions” scenario (e.g. if coal plants close more quickly than expected) the reforms will not remove the surplus on the market by the end of Phase 4, carrying a surplus of over 2Bt into the 2030s.
- **No amendments currently on the table address the impact on the market surplus of overlapping policies for power sector emission reductions**, despite the potentially large cancellation of allowances stored in the MSR. We therefore believe that the withdrawal rate of the MSR should be increased beyond 24% for the whole period 2021-2030.
- Most importantly, **the changes would represent only a temporary fix to a structural problem, which requires a structural response.** The disconnect between the cap and real emissions is the main reason why the EU ETS is not delivering its intended price signal, failing to drive the emission cuts taking place.

We continue to believe that the best solution is to remove surplus from the market quickly by readjusting the starting point of the Phase IV cap to reflect the real-world level of emissions. **The European institutions have correctly decided to link the Effort Sharing Regulation to real emissions; the same should be done for the ETS.** It's a simple question of taking stock: we can't expect the EU to land in 2040 using emissions estimates from 2007, and this exercise will have to be done periodically.

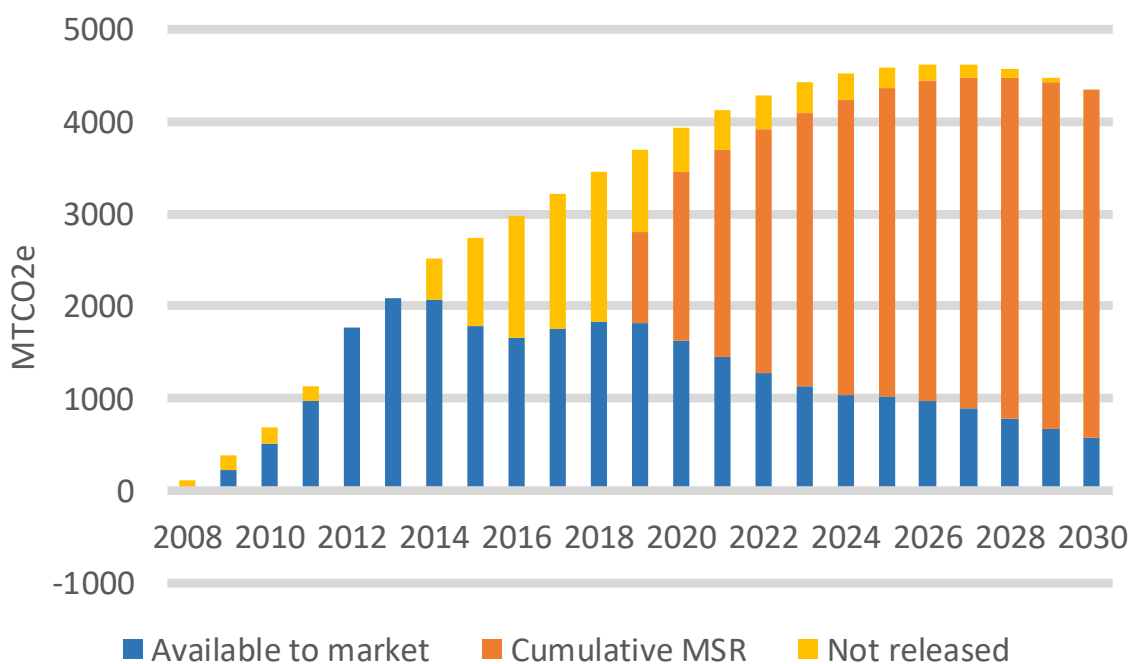
What is “the surplus”?

The surplus in the system represents the excess of allowances and offsets over emissions. The accumulated [surplus](#) to date actually comprises two elements: the surplus available to market, often just referred to as the “surplus”; and the surplus that has not yet been released to market and is currently “in limbo”.

The surplus available to the market comprises allowances that have been issued and are available to use for compliance by covered entities. These EUAs have either been allocated for free or auctioned, and they are currently held in the registry accounts of ETS installations and other market participants such as banks or carbon traders. The concept of allowances in circulation as defined in the [MSR decision](#) to a large extent covers the same idea.

The surplus that is not available to the market comprises allowances that have been issued but will only be released at some point in the future. In Phase 3, this consists primarily of allowances withheld from auctioning due to “backloading” as well as some as yet unallocated EUAs. Most of these allowances will be transferred to the MSR by 2020, as illustrated in the chart below.

Fig. 1 Current and expected surplus in the EU ETS and its components¹



¹ Scenario using our base emissions and the General Approach proposal as adopted by Council. Early Phase 3 auctions conducted in 2012 are not considered, this explains negative balance in 2013. Allowances not released in Phase 4 comprise the 470Mt transferred from Phase 3 (NER, Innovation fund, Greek island energy supply) are assumed to be released in equal instalments over Phase 4. No cancellation

The effects of the two surpluses

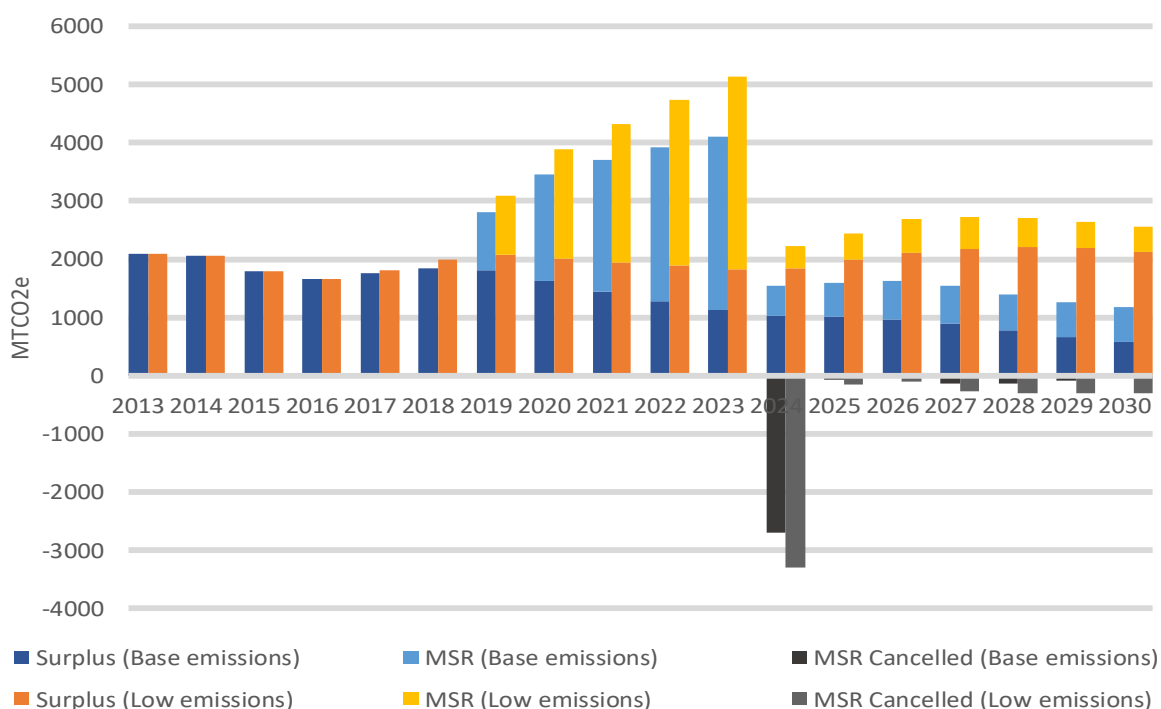
It is extremely important to distinguish between the two elements of the surplus since they exert very different effects on current market prices.

The surplus available to market represents the fundamental market balance as active market participants see it, and this is the primary basis on which the price signal is formed. On the other hand, the surplus that has not been released or will be in the MSR can only affect the current price because of a discounted expectation of the impact of the fundamental market balance some time in the future, specifically when the volumes in question actually become available to market participants. Theoretically, the market price should reflect both the current and expected market fundamentals. However, we have seen that in practice a much more short-term view of the market prevails and long to -medium term market tightness is not adequately reflected in current prices.

During the Environment Council on 28 February at least two options proposing volume limits on the MSR were discussed. The first proposed to limit the volume contained in the reserve to 650Mt, while the second proposed to limit the volume to the level of auctions of the previous year. Council ultimately adopted the latter, but neither will have an impact on the market balance until 2030. Under our modelling, the difference between the two is only about 50Mt in 2030. This is because, even after the cancellation, and under both of our emissions scenarios, the MSR will contain over 400Mt by 2030. According to current rules, this implies that no release from the MSR will occur during Phase 4 and therefore any limit on the amount the reserve can contain will only affect the market closer to the time that those allowances were due to be released i.e. after the end of Phase 4.

The European Parliament position calls for the cancellation of a fixed amount² of allowances. In terms of market impact, the reasoning outlined above remains very much valid, particularly because the amount to be cancelled is much smaller than in the Council proposal.

Fig. 2 Surplus and MSR dynamics under different emissions scenarios and Council proposal



² 800Mt in 2021

Concluding remarks and policy recommendations

Sandbag strongly supports the Council amendment on annual cancellation of allowances, and considers it to be qualitatively superior to all the other cancellation options on the table, including the initial proposal using a threshold of 650 Mt. The reason for that is simply that the current text introduces a much needed mechanism by which changes in real emission levels, as reflected in the quantities auctioned, have an impact on the surplus. While this only affects the surplus which is not available to the market and therefore shields the price of EUAs from a direct link to changes on the market in response to emission reductions, it creates an indirect link between the two.

We welcome this provision as it creates the foundation for the ETS developing from its current stagnant role to a more dynamic role of a coordinating climate policy, in touch with other developments affecting the installations it covers. As such, while other policies will inherently impact on the level of emissions and drive decarbonisation either on a sectorial or general level, this particular amendment on limiting the validity of allowances in relation to the amount auctioned the year below keeps the scheme in touch with reality, even if only through the glass wall of the MSR surplus.

Therefore, we make these policy recommendations for the trialogues:

- Sandbag urges the European Parliament negotiating team to **accept the Council text on the annual limits on the validity of allowances** as a great step forward out of the current dead-lock of the stagnant surplus plaguing the EU ETS;
- Sandbag further believes that the European Council would be well served to **accept the additional cancellation provided for in the Parliament draft (800Mt) and a New Entrant Reserve from within the Phase IV cap**;
- Sandbag urges both parties to **consider adding a measure to address the persistent surplus in the market**, which if unaddressed, would give us EUA prices too low to drive innovation – this can only happen if the supply and demand balance on the market is restored for the start of Phase IV.

About this briefing

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