

In a nutshell

- Our analysis shows that under the Council position, the use of the one-off flexibility between the ESR and the EU ETS would increase the total EU emission budget by 39 Mt. If it causes the ETS surplus to drop below the 833 million MSR threshold one year earlier, it could lead to an even much bigger increase in the total budget of up to 200 Mt;
- This would not only undermine the functioning of the MSR but also increases the (already high) risk that the EU misses out on its 2030 target;
- Amendment 48 of the European Parliament fixes this problem by preventing the one-off flexibility undermining the effectiveness of the Market Stability Reserve. The Council should accept this amendment as a strict minimum to ensure at least some notion of environmental integrity.

About Sandbag

Sandbag is a London and Brussels-based not-for-profit think tank conducting research and campaigning for cost-effective climate policies.

Our research focus includes accelerating the phase-out of old coal in Europe; reforming the EU Emissions Trading System and the Effort Sharing Decision; and deep decarbonisation of industry through technologies including Carbon Capture & Storage.

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How the flexibility between the ETS and the ESR increases the total EU emission budget

In October 2014, the European Council called for the establishment of a limited, one-off flexibility between the EU ETS and the ESR, **while preserving environmental integrity**. Based on these guidelines, the Commission has included the possibility to use 100 million ETS allowances for compliance under the ESR in the years 2021-2030. Member states that decided to make use of this mechanism for compliance under the ESR would have to cancel a corresponding number of emission allowances under the EU ETS.

It has been argued that the environmental integrity of this mechanism is guaranteed as the additional emission budget under the ESR would be countered by an equal reduction of the emission budget under the EU ETS. However, with the recent reform of the EU ETS – and in particular the introduction of a cancellation mechanism for excess allowances in the MSR – this argument is no longer valid. Due to interactions with the reserve, the use of this one-off mechanism would imply that member states would use ETS allowances under the ESR that would have otherwise been (at least partially) withdrawn and subsequently cancelled.

As illustrated below, our analysis shows that using 100 million allowances under the ESR under the Council position would only reduce the total emission budget under the EU ETS by 61 million EUA's¹. This is because the MSR would withdraw 39 million fewer allowances than under a scenario without use of the one-off flexibility. In other words, the total EU emission budget for the period 2021-2030 (ETS+ESR) would increase by 39 million EUA's. It also means that fewer allowances would be cancelled under the MSR².

¹ Assuming our low case emission scenario.

² For the cancellation mechanism, the lower volume in the MSR is partially compensated by a lower auctioning volume. Therefore, there is a difference of about 10 Mt between the decrease in total withdrawal and the decrease in total cancellation.

Table 1: impact of the one-off flexibility under the Council position (for the period 2021-2030, in Mt)

	No one-off flexibility	100 million one-off flexibility (Under the Council position)	difference
Total ETS supply	12,926	12,865	-61
Total MSR withdrawal	2,852	2,814	-39
Total MSR cancellation	4,883	4,855	-28

Moreover, there's a risk that the use of the one-off flexibility would cause the overall surplus on the ETS market to fall below the 833 million threshold one year earlier, which would undermine the functioning of the MSR even further. In the worst case, the one-off flexibility would cause the surplus to drop just below the 833 million threshold in the years in which the withdrawal rate is doubled. In that case, the MSR would withdraw and cancel about 200 million fewer allowances³ and **the overall EU emission budget would increase by 200 million tonnes.**

Amendment 48 to make the one-off flexibility budget-neutral

There are various reasons why the one-off flexibility between the EU ETS and the ESR should not be used at all (see for example our previous report on the ESR flexibilities: "[Bend It, Don't Break It](#)"). If both the Council as the European Parliament are set to maintain it anyway, they should at a very minimum ensure it does not increase the total emission-budget to preserve at least some environmental integrity.

The European Parliament has proposed that any ETS allowances that are cancelled under this one-off flexibility mechanism should not be subtracted when calculating the ETS surplus under the MSR mechanism (see their amendment 48). As illustrated in table 2 below, this approach would be effective in ensuring that the use of this mechanism is budget neutral and does not undermine the functioning of the MSR.

Table 2: impact of the one-off flexibility under the Parliament position (for the period 2021-2030, in Mt)

	No one-off flexibility	100 million one-off flexibility (with amendment 48)	Difference
Total ETS supply	12,926	12,826	-100
Total MSR withdrawal	2,852	2,852	0
Total MSR cancellation	4,883	4,893	10

The table above shows that Amendment 48 ensures that the real emission budget under the ETS decreases with 100 million tonnes in case the one-off flexibility mechanism is fully used. This because the functioning of the MSR would not be undermined. Due to a slightly lower auctioning volume, up to 10 million more allowances would be cancelled.

The Council should accept this amendment as a strict minimum to ensure at least some notion of preserving the environmental integrity.

³ If the surplus drops from 842 to 832 in 2021, 202 million fewer allowances (24% of 842) are withdrawn and cancelled. This situation is not unthinkable, as under the EU Reference scenario the surplus would be quite close to the threshold.

About this briefing

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