

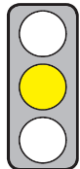
"MARKET STABILITY RESERVE" FOR EMISSIONS TRADING

cepPolicyBrief No. 2014-22

KEY ISSUES

Objective of the Decision: By introducing a "market stability reserve for emissions allowances", the Commission wants to remove what it perceives to be inequality between supply and demand in the EU emission trading scheme (ETS).

Affected parties: Operators of certain fixed installations, aviation companies.



Pro / Contra: The Market stability reserve is an instrument which fails to solve a problem that does not exist. Nevertheless, we do not expect it to have any significant negative consequences:

(1) Contrary to the Commission's view, the fact that the supply of allowances is fixed does not cause a problem. Quite the reverse; it has to be so in order that decisions are effectively controlled by the price.

(2) The market stability reserve does not have any substantial effect on the long-term price of allowances because the supply of allowances will not be permanently changed by putting them in the reserve.

CONTENT

Title

Proposal COM(2014) 20 of 22 January 2014 for a **Decision** of the European Parliament and of the Council concerning the **establishment** and operation of a **market stability reserve** for the **Union greenhouse gas emission trading scheme** and amending Directive 2003/87/EC

Brief Summary

Note: In the absence of any indication to the contrary, page and article numbers refer to the Proposal for a Decision COM(2014) 20.

► Background: EU Emission Trading Scheme

- The EU has undertaken to reduce its greenhouse gas emissions (GHG emissions) by 20% by 2020 as compared with 1990 levels (Art. 28 (1) Directive 2009/29/EC).
- Under the EU Emission Trading Scheme (ETS), the EU-wide level of permitted GHG emissions is limited ("cap"). Companies in certain sectors are only allowed to emit GHGs if they have a corresponding number of emission rights ("allowances"; Art. 12 (2)(a) and (3) ETS Directive 2003/87/EC; see [cepDossier EU Climate Policy](#), page 12 et seq.). This has applied,
 - since 2005, to certain fixed industrial installations – e.g. for supplying electricity and heat, metal production and processing, paper manufacture and the chemical industry – and also,
 - since 2012, to aviation.
- Allowances for fixed installations have been auctioned since 2013 apart from where they have been issued free of charge (Art. 3d (1)–(3) and Art. 10 (1) ETS Directive). The allowances for aviation have been auctioned since 2012.
- The procedure and timetable for the auctioning of allowances are governed by the Commission Auctioning Regulation (No. 1031/2010, s. [cepPolicyBrief](#)).
- Starting in 2013, the EU-wide total quantity of allowances is being reduced each year by 1.74% as compared with the average annual total quantity in the period 2008–2012 ("linear reduction factor", Art. 9 Directive 2009/29/EC).
- Instead of allowances, operators can also use international emission rights which have been acquired in the course of emissions reduction measures under the Kyoto Protocol (Art. 11a and 11b ETS Directive; see [cepDossier EU Climate Policy](#), p. 16 et seq.).

► Problem: Surplus of emission certificates

- In the Commission's view, the ETS is characterised "by a large imbalance between supply and demand of allowances" (p. 2).
 - There are currently a total of about 2 billion allowances in circulation which are not being used (total number in circulation or "surplus").
 - By 2020 the surplus is expected to rise to 2.6 billion allowances.

- The reason for the imbalance is the mismatch between the fixed supply of allowances and the flexible demand for them. "Usually" weakened demand results in decreasing supply (p. 2). This does not apply to the ETS.
- The imbalance "profoundly" affects the ability of the ETS (p. 2) to meet the GHG reduction targets cost effectively as, due to the low allowance prices, there is insufficient incentive to invest in technologies with low carbon emissions. In the long-term, this may increase the cost of climate protection ("carbon lock-in").
- The EU has already passed a Decision for the amendment of the ETS Directive (2003/87/EC) which amends the timetable for auctions by taking 900 million allowances (see [cepPolicyBrief](#))
 - off the market between 2014 and 2016 ("backloading")
 - and then putting them back up for auction between 2019 and 2020.
- Deferring the auction in this way will not permanently remove the surplus however.

► **Introduction of a "market stability reserve"**

– **How it works**

- By introducing a "market stability reserve" for certificates ("reserve"), the Commission wants
 - to remove what it perceives to be an imbalance between the supply of allowances and the demand for them (Recital 4) and
 - ensure an "optimal balance" between the carbon price signal and necessary investment in low-carbon technology ["intertemporal efficiency"; SWD(2014) 18, p. 3].
- Depending on the market situation, this "stabilisation" of the allowance market will be achieved
 - either by removing allowances from the market and placing them in the reserve, or
 - by releasing them from the reserve and channelling them into the market.
- The quantity of allowances to be placed in or released from the reserve is determined by the volume of surplus allowances in the previous year ("previous year's surplus").
- The Commission must publish the previous year's surplus by 15 May each year (Art. 1 (2)).

– **Definition of "previous year's surplus"**

- The previous year's surplus is made up of (Art. 1 (2))
- the total of all allowances auctioned since 2008 up to and including the respective
 - previous year,
 - allowances provided free of charge and
 - international emission rights deployed,
 - minus the total arising from
 - allowances claimed in respect of verified emissions from 2008 to the previous year,
 - the allowances cancelled at the request of the holder – e.g. because the latter wants to reduce the quantity of allowances for idealistic reasons – and
 - the allowances contained in the "market stability reserve" which is to be created.

– **Deployment of the "market stability reserve" as from 2021**

- The reserve will be deployed as from 2021 (Art. 1 (1)).
- Where the previous year's surplus was (Art. 1 (3) and (4))
 - more than 833 million allowances, 12% of the previous year's surplus will be placed in the reserve in the current year,
 - between 833 million and 400 million allowances, the number of allowances in the reserve in the current year will remain unchanged,
 - less than 400 million allowances, all the allowances in the reserve, up to a maximum of 100 million, will be released in the current year.

► **Additional flexibility measures**

- As from 2021, where the volume of allowances to be auctioned in a year exceeds the expected average volume of allowances for the two subsequent years, two-thirds of the difference between these volumes will be deducted from the volume of allowances for the year in question and shared equally between the two subsequent years (new Art. 10 (1a) ETS Directive).
- 100 million allowances will be released from the reserve if (Art. 1 (5) in conjunction with Art. 29a ETS Directive)
 - for a period of more than six consecutive months, the allowance price is more than three times the average price of the allowances in the previous two years,
 - the price trend is not the result of a change in market conditions and
 - the Member States were given the possibility of auctioning part of the volume of allowances earlier than planned.

► **Review and possible adjustment**

- By the end of 2026, the Commission must review the impact of the reserve on the functioning of the ETS and, if necessary propose additional measures (Art. 3).

Main changes to the status quo

Until now there has been no market stability reserve.

Statement on Subsidiarity by the Commission

According to the Commission, action at EU level is necessary because the ETS already operates in a harmonised manner EU wide (p. 4).

Policy Context

Due to the changes made by the Climate Package of 2009, (ETS-Directive 2009/29/EC, see [cepDossier EU-Climate Policy](#), p. 11 et seq.) the ETS has taken on increasing importance for EU climate protection policy since 2013: Up until 2012, every Member State laid down an annual national upper limit on available allowances and assigned them free of charge as part of "National Allocation Plans" (NAPs). Since 2013, an annual EU-wide total volume ("EU cap") has been established: For 2013, 1,926,876,368 allowances each equivalent to one tonne of CO₂, 2014 to 2020 linear reduction by a total of 21% on 2005 [Art. 9 ETS Directive; Commission Decision C(2010) 4658]. The allocation of allowances has also been subject to EU-wide harmonised regulation since 2013: Allocation free of charge is gradually being converted into auctioning so that since 2013 at least 50% of allowances have been up for auction and as from 2027 virtually all of them will be. By way of an exception, energy-intensive sectors in which there is "significant risk" of a cost-related migration to non-EU countries ("carbon leakage"), will continue to receive allowances free of charge after 2013 (Art. 10a (12)). The Commission already referred to an imbalance in the ETS in its 2013 report and proposed possible options for change [COM(2012) 652, see [cepPolicyBrief](#)]. This proposed Decision is accompanied by the Communication on climate and energy policy for 2020–2030 [COM(2014) 15, see [cepPolicyBrief](#)], in which the Commission proposes a 40% reduction in GHG emissions by 2030 compared with 1990 levels.

Legislative Procedure

22 January 2014	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Climate
Committees of the European Parliament:	Environment (leading), Rapporteur Sophie Auconie (EVP Group, F);
Federal Ministries:	Environment (leading)
Committees of the German Bundestag:	Environment (leading), EU Affairs; Transport, Economy
Decision-making mode in the Council:	Qualified majority (Adoption by a majority of the Member States and with 260 of 352 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 192 TFEU (Environment)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The market stability reserve will not substantially change either the basic characteristics of the ETS or the long-term volume of available certificates. It is ultimately therefore **an instrument which fails to solve a problem that does not exist. Nevertheless, we do not expect it to have any significant negative consequences:**

Ordoliberal Assessment

With the EU Emission Trading System (ETS), the EU has opted for an efficient instrument for GHG reduction. It provides a reduction target for the whole economy and leaves it up to the market players to find out where reductions are possible at the lowest cost.

In fact, by contrast with other more traditional markets, **supply in the ETS is fixed** and does not react to price changes. **Contrary to the Commission's view, however, this does not cause a problem. Quite the reverse; it has to be like this so that decisions are effectively controlled by the price** thereby ensuring that a policy-based upper limit is complied with at the lowest possible cost.

The Commission's fear, that too little investment in low-carbon technology will increase the cost of climate protection in the long-term ("carbon lock-in" problem), would only be justified if policy suddenly and

unexpectedly led to substantially stricter climate protection measures. This is within the Commission's own control however. Since the Commission has already proposed stricter emission targets for the period up to 2030 – reduction by 40% on 1990, annual linear reduction factor of 2.2% – [COM(2014) 15, see [cepPolicyBrief](#)] the likely climate protection requirements are foreseeable at least until 2030. Against this backdrop, since companies plan on a long-term basis, there is no likelihood of a rise in climate protection costs as a result of too little investment in low-carbon technology. It is therefore important that the affected companies are able to rely on the fact that there will be no intervention in the ETS and thus its credibility will not be called into question.

Fortunately, by contrast with its Report on the CO₂ Market [COM(2012) 652, see [cepPolicyBrief](#)], the Commission recognises that ETS is not price-based but volume-based. As a result of the reserve, the market-character of the ETS will be maintained as far as possible and pricing will be determined by supply and demand because the reserve will generally be activated where the preceding year's surplus is more or less than a specified allowance volume, irrespective of the price of allowances.

The market stability reserve is not expected to affect the long-term allowance price, and any effect it does have will only be marginal. Firstly, this is **because** allowances will only be placed in it where the previous year's surplus is above 833 million allowances. Secondly, in this case only 12% of the previous year's surplus will be placed into the reserve so unused allowances will still exist. Thirdly, the supply of available allowances will go up again in a timely manner – the previous year's surplus only has to be (just under) 400 million allowances. Fourthly, and most importantly, the supply of allowances will not be permanently affected by the reserve. The proportion of allowances moved into the reserve will be temporarily unavailable. **In the long term, placing allowances in the reserve will have no effect on the supply of allowances** – provided that no policy decisions are taken in subsequent years to take the allowances contained in the reserve off the market completely.

Detrimental effects on planning certainty for companies, caused by the market stability reserve, are at most peripheral because the way that the reserve works is based on clear rules which specify when allowances are placed in the reserve and when they are taken out. This does not allow policy-makers any scope for discretion.

Impact on Efficiency and Individual Freedom of Choice.

Negligible.

Impact on Growth and Employment

Negligible.

Impact on Europe as a Business Location

The introduction and implementation of the market stability reserve is neutral as regards location since it is not expected to give rise to any significant change in the price of allowances.

Legal Assessment

Legislative Competency

Unproblematic. The EU is empowered to issue environmental measures for the protection of the climate (Art. 192 TFEU).

Subsidiarity

Unproblematic.

Proportionality

Unproblematic.

Conclusion

The Market stability reserve is an instrument which fails to solve a problem that does not exist. Nevertheless, we do not expect it to have any significant negative consequences: Contrary to the Commission's view, the fact that the ETS has a fixed supply is not a problem. Quite the reverse; it has to be so in order that decisions are effectively controlled by the price. The market stability reserve does not have any substantial effect on the long-term price of allowances because the supply of allowances will not be permanently changed by putting it in the reserve.