# The Market Stability Reserve: where are we with the reform of the EU ETS?

On 5 May, European institutions reached a provisional agreement on the Market Stability Reserve (MSR), which has been endorsed by Member States and Members of the European Parliament's Environment Committee. This briefing details what was agreed and its implications for both the EU ETS and for the upcoming revision of the legislation to reflect the EU's 2030 climate and energy framework.

## Background to the MSR

After an 'emergency measure' to fix the EU ETS (the so-called backloading proposal) was finalised at the end of 2013 after tough political negotiations, the European Commission proposed a more substantial reform of the EU ETS in early 2014, by creating a Market Stability Reserve (MSR). Its purpose is two-fold, as the MSR has:

- a long-term goal of changing the basic design of the system to introduce greater flexibility and resilience to external shocks, and
- a short-term goal of reducing the existing oversupply in the market.

Simply put, it aims to add flexibility in the supply of the EU ETS and allow the system to operate like other markets would, whereby fluctuations in demand would be reflected by changes in supply levels. It also aims to rebalance the market in the short-term by placing some of the surplus allowances into a reserve if a certain threshold is exceeded, and return them to market at times when insufficient allowances are available from auctioning (see Box 1 for further information).

After the difficult political context in which the backloading proposal was negotiated, reaching an agreement on the Market Stability Reserve was not to be taken for granted. Moreover, discussions were put on hold for a few months because of the European elections, and a new power balance between the political groups emerged in the European Parliament.

## The agreement on the MSR (here)

We witnessed good progress in the MSR legislative process during the second half of 2014 and the beginning of 2015, which led to the first trilogue negotiation on 30 March 2015. After only two trilogue negotiation meetings between representatives of the European Parliament, European member states and European Commission, a provisional agreement was reached on 5 May.

### Box 1: The agreement on the MSR

**Start date**

- The MSR will be established in 2018 and shall operate from 1 January 2019

**Functioning of the reserve**

- Following the publication of the total number of allowances in circulation (ie, the cumulative number of allowances issued compared to the cumulative verified emissions since 2008) by 15 May of a given year, the auction calendars will be adjusted to take into account the allowances placed in or to be released from the reserve. The adjustment of the volume of allowances to be auctioned should be spread over a period of 12 months following the change to the relevant auctioning calendar from September onwards.
- The first publication shall take place by 15 May 2017.
- Each year, if the total number of allowances in circulation is higher than 833 million, a number of allowances equal to 12% of the surplus in circulation, will be deducted from the volume of allowances to be auctioned by Member States and will be placed in the reserve over a period of 12 months beginning in September of that year, unless the number of allowances to be placed in the reserve is fewer than 100 million.
- In any year, if the total number of allowances in circulation is fewer than 400 million, 100 million allowances shall be released from the reserve and added to the volumes to be auctioned. If the amount of allowances is fewer than 100 million allowances, all allowances in the reserve shall be released.
- In the first year of the reserve's functioning, placements will also take place, between 1 Jan 2019 and September of that year, of 8% of the total number of allowances in circulation.

**Measures to avoid shocks**

- In order to avoid disruptive effects from an imbalance between supply and demand levels for EU allowances at the end of one trading period and at the beginning of the next, the auction of part of the large supply at the end of one trading period will be postponed to the first two years of the following period.

**Unallocated allowances**

- Allowances not handed out from the New Entrants Reserve or not distributed because of installation closures by the end of Phase 3 will be placed in the MSR in 2020, instead of returned to market as originally foreseen in the ETS Directive.
- The Commission will review the ETS Directive in relation to those unallocated allowances and, if appropriate, submit a legislative proposal on options for further action. In addition, the European Commission has made a statement that the review will consider whether the

unallocated allowances should be used to address the risk of carbon leakage.

**Backloaded allowances**

- The 900 million backloaded allowances will be placed in the reserve instead of returning to market through auctioning in 2019-20.

**Review of the MSR & assurances on carbon leakage:**

- Within six months of the adoption of the MSR, the Commission will review the ETS Directive and in particular rules for free allocation and carbon leakage protection. This review will consider harmonised arrangements to compensate for indirect costs at the Union level.
- That review will also consider whether up to 50 million allowances should be used to supplement the existing NER300 before 2021 for low-carbon industrial innovation projects, including small-scale projects in all member states.
- The Commission will monitor the functioning of the MSR in the context of the annual carbon market report. This report will consider relevant competitiveness effects, in particular in the industrial sector.
- In addition, within three years of the MSR's start date, the Commission will review the functioning of the reserve and consider whether the rules on placing allowances in the reserve and releasing them are appropriate with regard to its aim of tackling the structural supply-demand imbalance. This will include an analysis of the market balance, considering the relevant factors affecting supply and demand, and of the appropriateness of the predefined range triggering adjustments to annual auction volumes, as well as the percentage rate applied to the total number of allowances in circulation. If the analysis indicates that the range is no longer appropriate in light of changed market developments, the Commission will submit a proposal to address this situation.

**Exemption:**

- Until 31 December 2025, the so-called "solidarity allowances" corresponding to 10% of total EUAs that are handed out to certain Member States for solidarity and growth purposes in the EU will not be taken into account when calculating the amount of allowances in circulation.

**MSR triggered by high price increases**

- If Article 29a of the ETS Directive is triggered, ie, if, for more than six consecutive months, the allowance price is more than three times the average EUA price during the two preceding years, then 100 million allowances will be released from the reserve and added to the volume of allowances to be auctioned. Where fewer than 100 million allowances are in the reserve, all allowances in the reserve shall be released.

## Why is reform necessary?

The structural imbalance in the EU ETS is undermining the cost-effectiveness of the system as the EU's central policy instrument for reducing emissions. The lack of investment in the EU is an indication that the system is currently not driving the necessary investments that will deliver the mid-to-long-term emission reductions.

In addition, some EU Member States have introduced additional policies that overlap with the EU ETS. These not only add costs to operators but also create competitive distortions in the EU's internal market.

Ensuring a well-functioning EU ETS is the most cost-effective way for the EU to meet its medium-term target of reducing its GHG emissions by at least 40% compared to 1990 levels by 2030 and its longer-term ambition of reducing its GHG emissions by 80-95% by 2050.

## Next steps in the MSR legislative procedure

European Member States, as well as Members of the European Parliament, endorsed the provisional agreement on the MSR. A vote in scheduled in the Parliament's plenary on 8 July. Once the text is endorsed, it needs to be rubberstamped by European Ministers (either in July or September).

After these steps, the MSR proposal will be published in the EU's Official Journal and become legislation.

## What happens after the MSR?

A legislative proposal to amend the EU ETS Directive is expected to be published by 15 July. This will translate into a legal proposal the political agreement that was reached by European Heads of States on the EU's 2030 climate and energy framework in October 2014. We expect changes to be proposed on the agreed level of GHG emission reduction (at least 40% reduction in GHG by 2030 compared to 1990 levels for the EU as a whole) and accordingly, on the cap of the EU ETS (a 43% reduction for ETS sectors by 2030 compared to 2005 levels); the creation of new 'funds' to stimulate innovation or encourage modernisation of the electricity sector; and also for new rules to protect EU industries against the risk of carbon leakage in a context of a declining cap in the EU ETS and a shrinking share of free allowances post-2020.

And of course there's Paris – the international climate agreement will most likely influence the EU's strategy. With the MSR and the tighter EU ETS cap, have we reached a turning point in addressing the challenge of the supply-demand imbalance? Longer-term considerations may encourage the EU to re-examine its domestic-only focus towards 2030. It is strategically important for the EU to recognise the possible use of international credits in the future; both for additional cost-efficient abatement options but also for international negotiation purposes – the more market-based instruments are developed, the more Parties are likely to engage in international efforts to reduce emissions, and the closer we will get to developing a global carbon market.

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