DON'T PILLAGE

The Market Stability Reserve

POLICY BRIEFING

EMISSIONS TRADING EXTRA

LIFE ETX

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LEGAL NOTICE

FURTHER INFORMATION

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INTRODUCTION

The Market Stability Reserve (MSR) is an important element of the EU Emissions Trading System. It has proven effective in supporting the carbon price, and helped end a period of very low confidence (and carbon prices) in the EU ETS. The MSR was created in 2015 to address the structural oversupply in the EU ETS, which amounted to a whole year's worth of pollution by the covered sectors, and started actively sucking surplus pollution permits out of the market in 2019. From 2023 onwards, it will also 'retire' (i.e. delete or cancel) emission allowances held in the reserve.

However, the European Commission now risks undermining the MSR and scaling back the progress it has helped achieve. The EU executive has proposed to pillage the MSR to sell some of the allowances it contains to finance the REPowerEU plan. The MSR is not a cookie jar that can be dipped into at whim - it is a critical component of the EU ETS that needs to be protected from raiders.

This REPowerEU plan seeks to reduce the impact of Russia's invasion in Ukraine by saving energy and diversifying energy sources. While a worthy policy goal, its details are damaging. The Commission intends to raise €20 billion by selling about 250 million allowances currently held in the MSR, in effect raising the amount of climate pollution allowed under the EU ETS, depressing carbon prices, reducing the incentives for industry to decarbonise, and undermining the EU carbon market by eroding trust in it and creating a damaging precedent. To add injury to insult, some of these funds would even be invested in fossil fuel infrastructure. Strict strings should be attached to all REPowerEU funding to make sure money is not sunk into climate damaging projects.

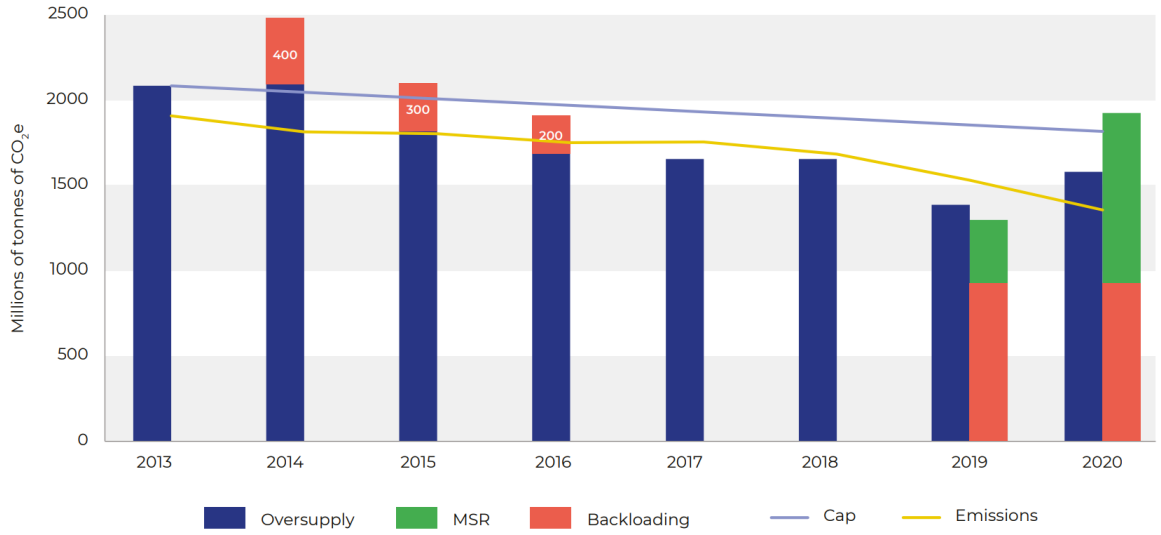
DESIGN FAULT

A separate longstanding challenge to the MSR is that it was only designed to tackle the historic oversupply, which will take years to absorb. It is not fit to deal with new sources of surplus or economic/geopolitical shocks (such as the COVID-19 pandemic, economic downturns and planned coal plant closures across the EU). Prior to the Russian invasion, national coal phase-out plans were on course to add another 2 billion emissions allowances to the oversupply during the current ETS trading period (2021-2030).

Therefore, policymakers must find alternative sources of funding for the REPowerEU plan and protect the integrity of the MSR. Selling allowances that were to be handed out for free is an objectively better way forward. In addition, the current EU ETS reform process must be used to strengthen the MSR by supporting the European Parliament's position to help ensure any new oversupply of emission allowances is kept from sinking the carbon price again. The key is to ensure the MSR absorbs surplus permits at a higher rate by increasing the so-called intake rate), and steadily decrease the thresholds that determine when permits are absorbed or released.

What is the Market Stability Reserve?

During Phase 2 of the EU ETS (2008-2012), a massive oversupply of emission allowances (EUAs) built up. This was caused by an overgenerous setting of the cap, too many allowances handed out for free, the use of 1.5 billion cheaper international credits and an economic downturn. The pile of oversupplied EUAs increased year by year between 2008 and 2020 because emissions were always lower than the total amount of emissions permitted by the EU ETS cap. By 2013, there were over 2 billion surplus EUAs in circulation, depressing the EU carbon price to between €5 and 10 a tonne of carbon (more details on the sources and evolution of the oversupply can be found in 'EU ETS 101- A beginner's guide to the EU's Emissions Trading System'). First, a quick fix was implemented which involved the 'backloading' of allowances on the auctioning calendar: 900 million EUAs were taken out of circulation between 2014 and 2016 to be auctioned later. In the end, these allowances ended up in the Market Stability Reserve.



Source: EU ETS 101- A beginner's guide to the EU's Emissions Trading System

The MSR itself was finally created in 2015. The reserve started actively sucking surplus EUAs out of the market in 2019, and helped end a period of very low confidence (and prices) in the ETS. The MSR has been strengthened since, and will also automatically cancel EUAs held above the absolute number auctioned the year before from 2023 onwards.

VOLUME CONTROL

The MSR is a supply management tool which focuses on volumes rather than prices. It is in essence a digital account where surplus EUAs are parked. The logic behind it is that while demand for allowances (emissions) is flexible and affected by economic or geopolitical shocks, the supply of EUAs is rigid. The MSR adds a measure of flexibility on the supply side by potentially changing the amount of EUAs annually entering into circulation.

The European Commission calculates the oversupply each year. This so-called total number of allowances in circulation (TNAC) represents the number of allowances that left the market minus the number of allowances that have entered the market. If this quantity is greater than 833 million, a percentage of the

oversupply is transferred to the MSR (the so-called intake rate of 24% until 2023, and 12% from 2024 onwards, which is set to rise to 24% under the current reforms being negotiated).

If the oversupply is lower than 400 million, the market is considered by policymakers 'too tight' and the following year an additional 100 million EUAs are withdrawn from the MSR and auctioned.

REPowerEU or DEPowerEUETS?

In response to the energy market disruption and price spike caused by the Russian invasion of Ukraine, the European Commission came forward with the REPowerEU Plan proposal in May 2022. Its two stated goals are to end the EU's dependence on Russian fossil fuels and to tackle the climate crisis. It would do so by saving energy, diversifying the EUs energy supplies and rolling out of renewable energy faster.

The plan would be largely financed by reallocating or relabelling existing budgets - with the only new funds to be raised by plundering the Market Stability Reserve. Allowances that are currently in the MSR awaiting deletion would be auctioned to generate €20 billion in revenues (this would require about 250 million allowances, depending on the carbon price). This would inflate the EU ETS cap and emissions under the EU ETS by 116 to 144 million tonnes of carbon dioxide equivalent (CO_2e) by 2030 - undermining climate action during the critical decade for tackling the climate breakdown.

Selling up to 250 million allowances could also significantly depress carbon prices and reduce the auctioning revenues that currently go to the member states or are used to fund climate-friendly innovation in the EU. If the carbon price drops significantly by the raiding of the MSR, it could become a zero-sum game where member states receive funds through REPowerEU that they would otherwise have received directly from auctioning. However, a steep price drop could even lead to an overall decrease in member state income by lowering EU ETS revenues for years to come. The impact on prices and revenues will depend heavily on the outcome of the EU ETS reform process and the detailed implementation of REPowerEU.

The damage that this proposal would cause to the carbon price would not be restricted to EU ETS revenues alone - lowering the carbon price would reduce the

incentive for polluters to clean up their act. Industrial emissions declined by a paltry 1.3% between 2013 and 2019 (the last pre-COVID year), and lower carbon prices will only further slow down the necessary transition to climate-friendly industry.

SMASHING THE PIGGYBANK

Furthermore, by dipping into the EU ETS solely to fill coffers once, the spectre of potential future raiding parties arises. A dangerous legal precedent is created where the MSR stops being a tool for market stability, but becomes a piggy bank to be smashed open at will. This would fundamentally alter the perceived role of the MSR, and its impact on confidence in the EU ETS - undermining carbon prices in the mid-to-long term as well. Moreover, it would set an unacceptable precedent of prioritising revenue raising over the environmental impact of climate policy.

While these concerns on loss of trust and lower carbon prices might seem hypothetical, they have actually already come to pass: the EU ETS price dropped by nearly 15% in the days following the publication of the proposal.

The Commission's proposal, which is risking long-term damage to the EU carbon market, is rightly controversial. It has worried the European Court of Auditors, some EU countries, European parliamentarians from across the political spectrum, as well as business and civil society stakeholders.

To make matters worse, REPowerEU also plans to invest around €11.5 billion in fossil gas and oil infrastructure, made possible by waiving the "Do no significant harm" (DNSH) obligation for the REPowerEU parts covering the diversification of fossil fuel sources. This would increase the EUs dependence on fossil fuels, create stranded assets and fossil fuel infrastructure lock-in. Absurdly, investments in renewable energy would have to comply with DNSH, while a new gas terminal would not. The rationale given is that there is a need to guarantee short-term security of supply to rapidly decrease Russian fossil fuel imports. However, this completely misses the mark as fossil fuel infrastructure (LNG terminals, pipelines etc) needs years to be built and cannot play a significant role in the short term.

FIXING REPowerEU

REPowerEU undermining the EU carbon market and investing in fossil fuels is not yet a done deal - these mistakes can still be rectified.

The DNSH obligation should not be waived for any investment or measure, so the exception in the proposal (Article 21c, paragraph 2.4) should be scrapped completely. EU funds should never harm the environment. The DNSH obligation, which is already being weakly applied, should, instead be strengthened across all EU funds. Reinforcing DNSH could be done by attaching stronger strings to the use of REPowerEU funds, such as demanding that any investment must be fully in line with the transition to a fully renewable energy system, and barring investments in fossil fuel infrastructure.

FEWER FREEBIES

It seems that the political imperative is such that new sources of funding need to be found, and that the ETS is to play a role in providing that funding. If so, then there are much better alternatives paths to raise funds within the ETS framework than the MSR, without undermining the integrity of the carbon market, the carbon price and stakeholder confidence in the scheme.

The primary way to raise additional funds through the ETS is by auctioning allowances instead of handing them out for free. Free allowances undermine the polluter pays principle, and the European Court of Auditors has found that free allocation is slowing down the decarbonisation process. Over the entire history of the EU ETS, about half of all allowances have been freebies, with very little to show for it in terms of emission reductions, especially in the industrial sector.

Reducing free allocations by 200-250 million allowances (about a third of annual free allocation) could raise the €20 billion required for REPowerEU. Nearly 5 billion allowances will likely still be handed out for free in the period between 2021-2030. Auctioning free allocation would not inflate the cap nor would it have a significant negative impact on the carbon price in the short, medium or long term. This could be linked to a better targeting of free allocation in general, an approach the Commission has already investigated in the impact assessment accompanying its EU ETS reform proposal.

Part of the required revenues could also be funded by pooling allowances already set to be auctioned for the member states - promoting solidarity between EU countries. These revenues would, however, not be additional, as auctioning revenues are already earmarked for member states to spend. A combination of auctioning free pollution permits and pooling allowances from the existing auctioning calendar could be a good middle ground: raising additional revenues while also promoting intra-EU solidarity. Free allocation and allowances already set for auctioning could each contribute 50% of the sought after 20 billion euros.

Alternatively, auctioning of free allowances could be complemented with 50% of funding coming from allowances earmarked for the Innovation Fund instead of from allowances earmarked for auctioning. The impact on the functioning of the Innovation Fund would be minor, with roughly 10% of its planned funding going to REPowerEU. The Commission is already planning to use the Innovation Fund as a tool for disbursing funds from REPowerEU, so using Innovation Fund allowances could potentially be revenue neutral for the Innovation Fund itself.

The advantages of using these sources over plundering the MSR is clear. They do not affect the cumulative emissions allowed under the EU ETS and will have a far more moderate impact on carbon prices . Importantly, they would also not undo hard-won gains in confidence in the carbon market.

CONCLUSION

Policymakers should make sure REPowerEU does not harm the EU carbon market or the transition to climate neutrality.

Draining the MSR will undermine the functioning of the carbon market, result in more climate damaging emissions and destroy confidence in the market. Long term damage to the carbon market should not be the outcome of a purported effort to become less reliant on fossil fuels.

Clearly, revenues should not be raised using the MSR, especially as alternatives exist. Free allocation is objectively a far more appropriate source of additional revenues (potentially in combination with pooling of allowances that were already set to be auctioned or allowances earmarked for the Innovation Fund).

In addition, the 'Do no significant harm' obligation should be strengthened rather than waived, to ensure EU funds and investments are fully aligned with the Paris Agreement and the EU's commitments to tackle the climate breakdown.

The REPowerEU plan cannot be kept separate from the ongoing trilogue negotiations surrounding the reform of EU ETS. Attempts to undermine the integrity of the EU carbon market should be taken seriously, and if needed the negotiators should add measures to prevent the potential damage to the MSR done by REPowerEU. Instead, negotiators should focus on shoring up and strengthening the EU ETS and the MSR itself.

The European Parliament's position on reforming the EU ETS is the best approach on the table to ensure the carbon price is not sunk again by oversupply building up in the system again.