

EFET Position Paper on the European Commission proposal for a Market Stability Reserve



20 November 2014

- We welcome the proposal to introduce a Market Stability Reserve (MSR) in the EU Emissions Trading System (ETS).
- An MSR should be implemented before 2018 to address the current imbalance between supply and demand and, even more urgently, to avoid intensifying it.
- The 900 million back-loaded emission allowances should be transferred into the reserve instead of returning them to the market.
- The rate of extraction should be higher than 12% to ensure the swift reduction of the current oversupply and return to scarcity.

The European Federation of Energy Traders (EFET)¹ welcomes the 40% greenhouse gas (GHG) emissions reduction target, set by the European Council in their Conclusions on the 2030 Climate and Energy Policy Framework from 23 October 2014. We – as EFET and almost all other stakeholders – take this as a clear signal that the EU Member States are convinced that **the EU ETS should continue to play the central role in Europe’s climate change policy: *emissions trading is economically efficient* – delivering GHG reductions at the lowest possible cost – and it creates a clear price signal, which facilitates the allocation of capital towards low-carbon investment.** To achieve its objectives, however, an emissions market requires an expectation of future scarcity to create long-term price signals.

Currently, the combined effect of overlapping policies and the economic downturn has dampened the demand for allowances. This has resulted in a massive oversupply, which prevents the establishment of any meaningful CO2 price signal. We expect this oversupply to continue well beyond the end of Phase 4, if it is not

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, liquid and sustainable wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

addressed properly in a comprehensive and coherent reform. As a consequence, many industry participants are, and will remain, 'long', and therefore, will not participate in the market. This lack of variety in players will translate into further price volatility - the wrong, erratic type of volatility, leaving the market exposed to price shocks, which, in turn, risks the acceptance of the ETS as such.

In addition to a longer-term target of a GHG reduction of 40% compared to 1990 in 2030, as agreed by the Council Conclusions, which will already contribute to restoring the credibility of the EU ETS, it is necessary to make the system robust to exogenous shocks by absorbing the current oversupply and preventing such situations from occurring in the future. **We, therefore, welcome the proposal to introduce an MSR. The MSR has the capacity to reduce the oversupply**, which would make the market more attractive, and **could help to reduce price volatility** by ensuring a healthy balance between supply and demand at all times.

As a standalone measure, the MSR must impact the EU carbon market in two ways: first, by *addressing the current oversupply and avoiding the build-up of future oversupply*; and second, by *smoothing the expected price shocks when the supply-demand balance becomes tight* (a function which, in theory, should be fulfilled by speculative market participants, such as pure traders and banks, but, partly due to the lack of confidence in the long-term viability of the system, it is not certain that it will). **If the MSR is designed appropriately, it will return the market to a supply-demand balance that will attract a healthy variety of market participants, which, in turn, will deliver a robust price signal.** The MSR could achieve this in a predictable, rule-based manner, avoiding *ad hoc* regulatory intervention.

To avoid delaying the impact of the MSR, the 900 million back-loaded emission allowances should be transferred directly into the reserve rather than returned to the market. If the back-loaded allowances are auctioned first, as currently foreseen, they would only contribute to the existing oversupply, which would lead to a further price collapse. The ETS may not survive another considerable increase in the already damaging supply-demand imbalance. As a consequence, national and EU policy-makers may turn away from the system, leading to more administrative and fewer market-based decarbonisation policies. Such policies risk creating intra-European carbon leakage, as unilateral measures would establish an uneven level-playing field. Moreover, policy fragmentation could also lead to excessive societal costs in reaching the decarbonisation objective. And to be able to transfer the back-loaded allowances directly into the MSR, **the reserve should be set up before 2018. Only then it will be able to address the current supply-demand imbalance and, even more urgently, will avoid intensifying it.**

The rate of extraction should be higher than 12% to ensure the swift reduction of the current oversupply and return to scarcity. This would send a clear signal of support for the EU ETS. The proposal for increasing the extraction rate by introducing a supply adjustment equal to 33% of the difference between the surplus and the upper end of the band, introduced by Sandbag², for instance, should be

² The Sandbag response to the Commission's proposal for a Market Stability Reserve is available here:

http://www.sandbag.org.uk/site_media/pdfs/reports/Policy_Briefing_on_the_Market_Stability_Reserve.pdf

considered, as it could help to accelerate the extraction rate when it is most needed, while slowing it down as we get closer to the target.

The immediate reduction of the existing surplus of allowances is essential for ensuring the survival of the most efficient mechanism for reducing carbon emissions – the EU ETS. Beyond its mere survival, however, the ability of the EU ETS to deliver on its decarbonisation objectives will require more comprehensive structural reforms to restore trust and confidence in the system. To this end, we would welcome the prompt implementation of an MSR in conjunction with a comprehensive package of structural measures to reform the EU ETS. Our success in achieving the EU climate policy objectives would largely depend on the ability to ensure consistency between the cap and trade system and the EU policies on renewable energy and energy efficiency.