Climate Markets & Investment Association

The EU ETS, Market Stability Reserve and Phase IV
28 August 2015

CMIA Policy Paper

CMIA welcomes the improvement which the Market Stability Reserve has brought to the EU ETS. The MSR is the structural change which gives the ETS greater flexibility and responsiveness to handle extreme external shocks such as recession. Policymakers and legislators should be praised for piloting the legislation through speedily so that the MSR will be in place by 2019,

However, we are disappointed that, even with the MSR in place, the amendment proposed by the Commission on 15 July 2015 will not fulfil several aspects of the mandate given by the Council in October 2014:

- the ETS still fails to achieve what it says it does: 43% emissions reduction from 2005 levels by 2030;
- moreover , it fails to make any contingency proposal to achieve at least 40% reduction in EU emissions from 1990 levels, should the EU need to move to higher ambition;
- it does not properly align allocation with production levels, which creates perverse effects

We therefore propose that the Commission revise its proposal to better achieve the above goals, by:

- Adding a condition to the release of MSR allowances to better match the 43% target and removing provisions through which phase 3 allowances can skip the MSR
- if a successful agreement is reached in Paris, raising the EU's level of ambition with the help of carbon credits
- Creating a real incentive for companies to reduce emissions (not production) through dynamic allocation
- Amending the list of trade-exposed sectors to better differentiate them by degree of exposure.

1. Achieving 43% reduction from 2005 for ETS sectors

The MSR is a significant improvement for the EU ETS. For many years, CMIA has criticised the inconsistency between the emissions reduction goal which the ETS pretends to achieve and the real constraint it imposes once its huge surplus of allowances is taken into account. CMIA had repeatedly urged the Commission to adopt a "supply control mechanism" which would remove from the market part of the surplus under specific conditions, first in October 2012[1] and again in December 2012[2]. Back then, we had calculated that the real constraint imposed by the ETS still allowed emissions to increase by 2020, which was at odds with the claimed 20% reduction below 2005 levels.

We therefore welcome the Commission's initiative to establish a mechanism based on the removal of EUAs to curb the scheme's oversupply, and their work in steering it through the legislative process. The MSR, as it was set up in 2014, partly corrects the above design flaw by forcing emissions into a downward trajectory. However, by allowing the release of 100m EUAs from the reserve (5% of 2005 emissions) every year in case of shortage, the EU is still allowing ETS emissions to exceed their cap by 5% every year. Given that the cap is set to linearly decrease to 43% below its 2005 level by 2030, the emissions from ETS sectors will be allowed to linearly decrease by only 38%. Although the MSR has improved the previous situation, its flexibility does not fully address the problem, and on the current Commission proposal it will fail to ensure that "the reductions in the ETS sectors amount to 43% by 2030".

In order to meet the 43% reduction goal, we would have expected a policy attenuating the effect of the 100m released EUAs in the run up to 2030, to better align the supply with the scheme's claimed target. Instead, in its July text the Commission proposed two back doors through which EUAs can "escape" from the MSR, thus allowing emissions to exceed the cap even further:

- - The proposal dedicates 250m EUAs from the MSR to "new entrants and significant production increases". No need for a shortage then as the MSR is available regardless of the supply/demand balance.
- - It also lets unallocated Phase 3 EUAs (about 150m) feed the new entrants reserve directly.

[1] CMIA's response to the EC's public consultation on backloading
http://ec.europa.eu/clima/consultations/docs/0016/organisation/cmia_en.pdf

[2] CMIA's response to the EC's public consultation on structural options to strengthen the EU ETS
http://ec.europa.eu/clima/consultations/docs/0017/organisations/climate_markets_en.pdf

- - It lets 50m EUAs from the MSR be sold to “supplement” the NER400.

So with the proposed text, about 450m EUAs which would otherwise have been channeled into the MSR are up for grab which further weakens the effective cap.

What we propose:

We believe the EU should calibrate its climate policy instruments in line with its international commitments, and remove these “back doors”. To this end we propose:

- the release of EUAs from the MSR each year should be blocked when the cap has been exceeded in the previous two years. This would help emissions meet the cap at least once every three years, while currently an MSR filled with 2bn EUAs could let emissions exceed the cap for 20 years on.
- To delete all features from the proposed directive which allow surplus phase 3 EUAs to skip the MSR and flow into phase 4.
- To channel unallocated (phase 4) allowances into the New Entrants Reserve. This, together with our last suggestion in §4 below, would ensure there are more allowances available to production increases in trade-exposed industry, instead of using phase 3 surplus EUAs as currently envisaged.

2. Achieving <u>at least</u> 40% reduction from 1990

In October 2014, the EU Council conclusions committed to reduce the block’s emissions by “at least 40%” from 1990 levels. Although the “at least” part of the sentence was repeated in the Commission’s proposal, the system it lays out provides no incentive for over-achieving the 40% goal (quite the opposite, the incentive is to achieve less than the target, as seen above).

We regret that the proposed amendment does not include similar language on increased ambition as the current version of the Directive, in which Europe committed to up its reduction target in the event of an international agreement.

What we propose:

We believe that the EU should preserve the spirit of the current Directive by taking an extra voluntary commitment in case a sufficiently ambitious treaty is signed in COP21. Such a treaty would make it necessary to at least align EUA supply with the EU’s 40% claimed target as suggested in §1, for compliance purposes. We propose, in such event:

- to raise the level of ambition to 50% (instead of 40%). If a reform such as suggested in §1 is not implemented, the “effective” target would in fact be less, thanks to the release of MSR allowances.
- To allow the use of CERs as a complement to EUAs for compliance, so as align the effective cap to a 40% domestic reduction.

3. Aligning allocation with production

With its grandfathering allocation system, the ETS has historically raised the profitability threshold for industries to produce goods in Europe, by granting them the possibility to earn money for not producing. Any EU emitter faces the choice of losing the proceed of an EUA sale vs. producing each unit of output. For trade exposed sectors, this favours carbon leakage, as:

i) even the most carbon efficient installations are incentivised to stop producing;
ii) domestically produced goods become more expensive, as the opportunity cost of not selling the allowances feeds into marginal costs;
iii) equivalent imported goods, unconstrained by a similar system, become relatively more profitable regardless of carbon intensity.

The proposed text only partially addresses this problem by adjusting free allocation symmetrically in case of “significant production increases” or decreases. Although the threshold for significance is not specified, it is illustrated in the impact assessment with a 15% figure.

One problem with the proposed threshold system is that it leaves the marginal cost issue unsolved within a +/-15% production range. Another is that it creates an incentive to game the system in the following way: a company owning two similar plants A and B can leave its production unchanged (raising output by 15% in plant A and reducing it by 14.99% in plant B) while claiming 7.5% more free allocation! Such policy would very probably lead to:

- an overall increase in those sectors' allocation even as production decreases or remains constant;
- distortion of competition between companies owning a large fleet of plants (which can game the system) and smaller companies (which can't);
- necessity to apply a correction factor to allocation (ensuring the cap is not exceeded), which creates uncertainty for producers.

What we propose:

The above perverse incentive would be cancelled if allocation was made strictly proportional to output. Ideally, industries exposed to foreign trade (whose products may be substituted by imported goods) should pay for their carbon inefficiency only. To create such incentive, we propose:

- To apply a fully dynamic ex-post allocation method.
- To channel unallocated allowances into the New Entrants Reserve (as mentioned in §1). This, together with our last suggestion below in §4, would preserve a larger number of allowances for production increases in the more exposed sectors, instead of using phase 3 surplus EUAs as currently envisaged. It would also reduce the need for applying a correction factor, as allocation would more likely remain below the industry cap.

4. Amending the list of trade-exposed sectors

The proposed list represents 93% of ETS emissions. Although it slightly better filters exposed sectors than the previous list (which covered 97% of emissions), it makes no distinction between degrees of exposure. We believe that providing excessive support to less exposed carbon-intensive sectors:

- discourages investment in alternative products, which become relatively less profitable;
- unnecessarily consumes EUAs which could potentially be allocated to production increases in the more exposed sectors.

The level of free allocation should therefore be more carefully adapted to the level of trade exposure. To this end we propose:

- To differentiate between "fully-exposed" and "partly-exposed" sectors in two separate lists and allocate fewer free allowances to the latter category.

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Editor's notes:

About the CMIA

The Climate Markets and Investment Association (CMIA) is the voice of the international climate finance community. Governments and policy makers across the world recognise and engage with CMIA as a leader amongst progressive trade associations with regards to enabling and incentivising economically efficient climate investment, whether through market mechanisms, direct government and multilateral agency funding or solutions that blend public and private sector finance. CMIA's strength lies in its convening power across a broad spectrum of the business and finance community involved in climate change. We apply the output of members' active participation, their collective experience and technical expertise to help inform international policy makers, government departments and law makers, enabling them to develop and implement effective market & finance solutions to combat climate change.