Union greenhouse gas emission trading scheme: establishment and operation of a market stability reserve

2014/0011(COD) - 22/01/2014 - Legislative proposal

PURPOSE: to establish a market stability reserve for the EU Emissions Trading System (EU ETS)

PROPOSED ACT: Decision of the European Parliament and of the Council.

ROLE OF THE EUROPEAN PARLIAMENT: the European Parliament decides in accordance with the ordinary legislative procedure and on an equal footing with the Council.

BACKGROUND: at the start of the third trading period (2013-2020), the EU ETS was characterised by a **large imbalance between supply and demand of allowances**, resulting in a **surplus of around 2 billion allowances** that is expected to grow over the coming years to more than 2.6 billion allowances by 2020. The reason for this imbalance is primarily a mismatch between the auction supply of emission allowances, which is fixed in a very rigid manner, and demand for them, which is flexible and impacted by economic cycles, fossil fuel prices as well as other drivers. Weakened demand usually goes together with decreasing supply. However, in the EU carbon market this is not the case for auction supply in the current regulatory regime.

The EU ETS was set up to deliver EU emissions reduction goals in a harmonised and cost- effective manner. While the environmental objective is guaranteed by the cap, the presence of **a large surplus reduces the incentives for low-carbon investment** and has a negative effect on the cost-efficiency of the system. In short, if not addressed, these imbalances will profoundly affect the ability of the EU ETS to meet the ETS target in future phases in a cost- effective manner.

The Commission report on the state of the European carbon market in 2102 identified the need for measures to tackle structural supply-demand imbalances. This imbalance is expected to continue, and would not be sufficiently addressed by adapting the linear trajectory to a more stringent target within this framework. A change in the linear factor only changes gradually the cap. Accordingly, the surplus would also only gradually decline, such that **the market would have to continue to operate for more than a decade with a surplus of around 2 billion allowances or more.** In order to address this problem and to make the European Emission Trading System more resilient to imbalances, a market stability reserve should be established.

IMPACT ASSESSMENT: the impact assessment shows that :(i) the establishment of a market stability reserve could help address the current imbalances; (ii) such a reserve would make the ETS more resilient to any potential future large-scale event that may severely disturb the supply-demand balance; (iii) operating the market stability reserve in relation to the total number of allowances in circulation has the advantage of capturing changes in demand.

CONTENT: the proposal aims to establish a market stability reserve for the EU ETS, as part of the 2030 framework for climate and energy policies. This market stability reserve will **operate as of phase 4 starting in 2021** to provide market participants with the necessary certainty as regards the auction supply during phase 3 and an appropriate lead-time for the introduction of the reserve.

To ensure predictability, the market stability reserve is designed as an objective and rule- based mechanism on the basis of which the auction volumes are adjusted in an "automatic manner" under pre-defined conditions

Market stability reserve: the market stability reserve functions by **triggering adjustments to annual auction volumes** in situations where the total number of allowances in circulation is **outside a certain predefined range:**

- **adding allowances** to the reserve by deducting them from future auction volumes with the aim of mitigating market instability due to a large temporary surplus in the EU ETS **if the total surplus is higher than 833 million allowances;**

- **releasing allowances** from the reserve and adding them to future auction volumes with the aim of mitigating market instability due to a large temporary deficit in the EU ETS provided the total surplus is **below 400 million allowances**.

Allowances are thus placed in and released from the market stability reserve in relation to the **total number of allowances in circulation**. To ensure predictability and more gradual changes to the market stability reserve, a pre- defined volume of 100 million allowances per year would be released from the reserve where the conditions are met. This quantity represents roughly 5% of the current annual emissions in the EU ETS which based on historical experience should be sufficient to cater for even very sudden and strong increases in demand.

The proposal also contains provisions aimed at **smoothening auctioning supply in the years around transitions between trading phases** in cases where the default would otherwise have resulted in sharp changes. If the volume of allowances that should be auctioned in the last year of the period exceeds the average amount to be auctioned in the two following years by more than 30%, this difference will be evenly distributed over these years. This provision builds on the experience gained in the transition from phase 2 to phase 3 of the EU ETS.