

BRIEFING PAPER

# THE EU ETS REFORMS

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## CIEP BRIEFING PAPER ON THE EU ETS REFORMS<sup>1</sup>

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Having celebrated its tenth anniversary in 2015, the **European Union Emissions Trading System (EU ETS)** has become an important pillar of European energy and climate policies. Nonetheless, opinions vary widely as to whether it has been a success. The system currently has a large **surplus** in allowances, equalling close to **a years' worth of demand**. In the short term, this undermines the functioning of the carbon market, while in the longer term it will affect the ability of the EU ETS to cost-effectively meet stricter greenhouse gas (GHG) emission reduction targets.<sup>2</sup>

The past few years have seen various proposals to amend the system. Discussions have taken place on topics such as **back-loading**, the **2030 Framework for Climate and Energy Policies**, the **Market Stability Reserve** and the overall **Energy Union**.<sup>3</sup> Most recently, on **15 July 2015**, as part of its **Energy Union Summer Package**, the European Commission (EC) published a proposal to revise the system for its fourth phase, which will start in 2021.<sup>4</sup>

This **CIEP Briefing Paper on the EU ETS Reforms** serves to provide an overview of these developments and the discussions surrounding them. First, the context of the allowance surplus will briefly be discussed. Attention will then turn to the different solutions presented by the EC to intervene in the system. These interventions will be divided into **short-term** (back-loading) and **long-term** (2030 Framework, the Market Stability Reserve, and Phase IV reforms) components.

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<sup>1</sup> This CIEP Briefing Paper was first published in December 2015 and last updated on 04-03-2016. All links in this document were then up to date.

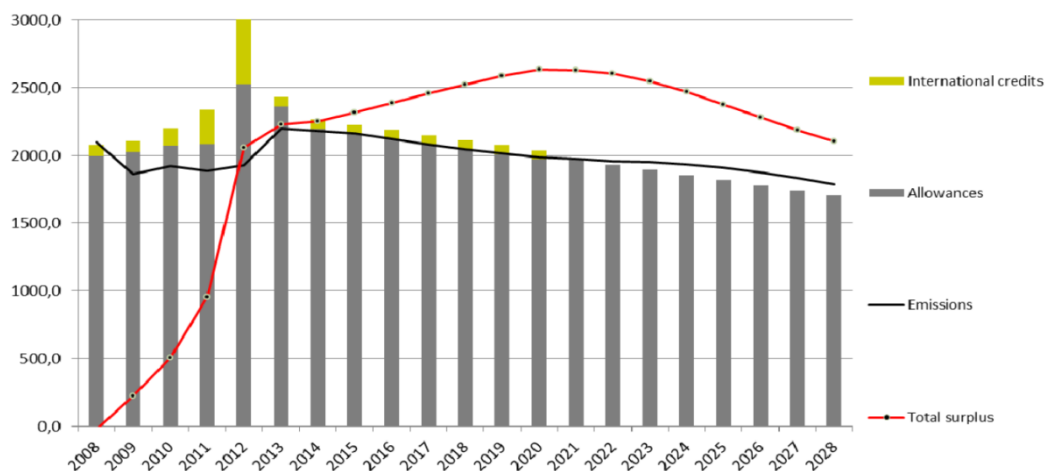
<sup>2</sup> European Commission (2015), 'The EU Emissions Trading System (EU ETS)', [http://ec.europa.eu/clima/policies/ets/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/index_en.htm).

<sup>3</sup> For an overview of the developments and discussions preceding the EC's Energy Union plans, please see 'CIEP Briefing Paper on the Energy Union' (April 2015), available at: [http://www.clingendaelenergy.com/media/briefing\\_papers](http://www.clingendaelenergy.com/media/briefing_papers).

<sup>4</sup> European Commission (2015), 'Proposal for a Directive of the European Parliament and of the Council Amending Directive 2003/87/EC to Enhance Cost-effective Emission Reductions and Low-carbon Investments', available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015SC0136>.

## Background: is the EU ETS failing?

Since the start of Phase II (2008-2012), a **surplus** of Emission Unit Allowances (EUA) has been building up in the EU ETS, see Figure 1.



**Figure 1.** This 2014 EC graph shows the historical and projected future profile of supply (i.e., the columns, divided in two components: *domestic* allowances and international credits) and demand (i.e., the black 'Emissions' line) up to 2028. The difference between the two is portrayed as the red line, 'Total surplus'. This projection excludes any measures such as back-loading, the Market Stability Reserve and the proposed revisions for Phase IV. The numbers are in millions of allowances.<sup>5</sup>

Simply stated, the amount of available emission allowances has not been in line with actual emissions over the years. Between 2008 and 2012, supply and demand diverged further each year, resulting in the increase of the surplus. As of today, it has accumulated to over two billion allowances, about a years' worth of demand. Figure 2 shows the development of the carbon price during that period, dropping from nearly €25/tCO<sub>2</sub> in 2008 to around €7/tCO<sub>2</sub> in 2012.

<sup>5</sup> European Commission (2014), 'Commission Working Staff Document, Impact Assessment', SWD(2014) 15 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014SC0015>.



Figure 2. Evolution of the EUA price 2008 – 2012 (Phase II).<sup>6</sup>

This divergence had several causes on both the **supply** and the **demand** side. The EC points to the large influx of international carbon credits and the economic crisis as the primary reasons behind the mismatch between supply and demand.<sup>7</sup> Moreover, unintended effects from policies supporting energy efficiency and renewables depressed demand for EUAs even further.

Because additional restrictions for the use of international credits have been applicable since the start of Phase III (2013-2020)<sup>8</sup>, the last year of Phase II saw a significant increase in their use, exacerbating the surplus of supply already present in the system, see Figure 1. For Phase IV, the EC's proposal sees no further role for international credits; EU GHG emissions reductions will have to come solely from domestic efforts.<sup>9</sup> Furthermore, as of 2013, an EU-wide moving 'cap' – in effect a limit – on emissions was introduced. This cap shrinks by 1.74% each year in accordance with the EU-wide GHG emissions reduction target of 21% by 2020 as compared to 1990 for the sectors covered by the EU ETS. A closer look at the CO<sub>2</sub> price development in Phase III shows that a nearly 50% drop occurred in the first months of 2013, from around €6/tCO<sub>2</sub> to just over €3/tCO<sub>2</sub>, see Figure 3. In absolute terms, however, this did not present much of a shock, due to the already big decline

<sup>6</sup> Based on data from Quandl (2015), available at: [https://www.quandl.com/data/CHRIS/ICE\\_C1-ECX-EUA-Futures-Continuous-Contract-1-C1-Front-Month](https://www.quandl.com/data/CHRIS/ICE_C1-ECX-EUA-Futures-Continuous-Contract-1-C1-Front-Month). The price refers to EUA Futures, Continuous Contract #1 (front month). For 2008 the data is available from 08-04-2008 onwards.

<sup>7</sup> European Commission (2014), 'Commission Working Staff Document, Impact Assessment', SWD(2014) 15 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014SC0015>.

<sup>8</sup> European Commission (2014), 'Questions & Answers on Implementation of Rules Regarding the Eligibility of International Credits in the EU ETS' (10/2014), [http://ec.europa.eu/clima/policies/ets/linking/faq\\_en.htm](http://ec.europa.eu/clima/policies/ets/linking/faq_en.htm).

<sup>9</sup> European Commission (2015), 'Proposal for a Directive of the European Parliament and of the Council Amending Directive 2003/87/EC to Enhance Cost-effective Emission Reductions and Low-carbon Investments', COM(2015) 337 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2015:337:REV1>.

over the preceding years. The modest price increase between then and December 2015, as visible in Figure 3, could be explained by the different initiatives taken to improve the functioning of the EU ETS, but also by increased confidence in economic growth. The collapse of the CO<sub>2</sub>-price since the beginning of 2016 is currently being attributed for the most part to external factors such as the overall downturn affecting nearly all relevant commodities such as oil, gas, and coal.<sup>10</sup> However, it remains to be seen whether a future price recovery in those markets will lead to an increase in the CO<sub>2</sub>-price.



**Figure 3. Evolution of the EUA price from January 2013 – February 2016.**<sup>11</sup>

Another important change since the start of Phase III is the significant increase in the share of auctioned allowances relative to cost-free allocation, expected to increase to up to 50% over the entire time period.<sup>12</sup> In Phase II, almost all allowances were freely allocated based on historical emissions, with only a few countries such as Germany, the United Kingdom, the Netherlands and Austria conducting auctions for a limited amount of allowances (up to 10% was allowed).<sup>13</sup> As will be discussed later, the EC has proposed to fix the auctioning share at 57% for Phase IV.<sup>14</sup>

The annual 1.74% reduction of the cap should ensure that the surplus of allowances will eventually, without any further interventions, start to decrease from around the

<sup>10</sup> Energeia (2016), 'CO<sub>2</sub> duikt onder EUR6, zicht op ETS-link met Zwitserland'.

<sup>11</sup> Based on data from Quandl (2016), available at:

[https://www.quandl.com/data/CHRIS/ICE\\_C1-ECX-EUA-Futures-Continuous-Contract-1-C1-Front-Month](https://www.quandl.com/data/CHRIS/ICE_C1-ECX-EUA-Futures-Continuous-Contract-1-C1-Front-Month). The price refers to EUA Futures, Continuous Contract #1 (front month). The last day is 19-02-2016.

<sup>12</sup> European Commission (2015), 'Auctioning', [http://ec.europa.eu/clima/policies/ets/cap/auctioning/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/cap/auctioning/index_en.htm).

<sup>13</sup> European Commission (2015), 'Phase 2 Auctions (2008-2012)', [http://ec.europa.eu/clima/policies/ets/pre2013/second/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/pre2013/second/index_en.htm).

<sup>14</sup> European Commission (2015), 'Proposal for a Directive of the European Parliament and of the Council Amending Directive 2003/87/EC to Enhance Cost-effective Emission Reductions and Low-carbon Investments', COM(2015) 337 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2015:337:REV1>.

start of Phase IV in 2021, as projected in Figure 1. Opponents of more intervention in the system point to this while also emphasising the generally positive countercyclical effect of there being a lower carbon price in times of reduced demand for allowances due to an economic crisis. Nonetheless, the EC deemed the surplus too big of a problem due to its sheer size and structural nature. Without any intervention the EC expects that even though it is gradually declining the surplus will not have disappeared by the end of Phase IV (2021-2030). By then, it will still represent over a years' demand, see Figure 1. In the short term, this undermines the functioning of the carbon market, and in the long term it will affect the ability of the EU ETS to meet stricter emission reduction targets in the future in a cost-effective manner.<sup>15</sup> The EC has therefore taken initiatives to address this structural oversupply.

### Back-loading: a quick-fix for the short term?

Already in the final year of Phase II, in an attempt to converge supply and demand, the EC looked into the option of postponing the auctioning of a total of 900 million allowances from the first years of Phase III until the end of the period. This supply-side intervention is known as **back-loading**. The EC stipulated that deductions were to take place from EUA auctioning in 2014 (400 million), 2015 (300 million) and 2016 (200 million). Back-loading does not change the overall number of allowances in Phase III because these allowances will be put back into the market during the final two years of the trading period, 2019 (300 million) and 2020 (600 million). However, postponing their auctioning can potentially increase government revenues, resulting from a higher CO<sub>2</sub> price, earlier in the trading period, something certainly welcome in times of economic hardship. After consultations, back-loading was accepted by the European Parliament and the European Council and implemented in February 2014.<sup>16</sup>

Apart from back-loading allowances, more structural and long-term solutions have also been proposed to strengthen the EU ETS in light of stricter GHG emissions reduction targets for 2030.

### The 2030 horizon and long-term solutions

In January 2014 the EC published a Communication called 'A Policy Framework for Climate and Energy in the Period from 2020 to 2030', also known as the **2030 Framework**.<sup>17</sup> Most notably, it proposed a **new GHG emissions reduction target of 40%** for 2030 as compared to 1990 levels. For the **ETS sector** this implied a reduction of **43%** compared to base year 2005, the year the system was introduced. The EC

<sup>15</sup> European Commission (2015), 'Structural Reform of the European Carbon Market', [http://ec.europa.eu/clima/policies/ets/reform/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/reform/index_en.htm).

<sup>16</sup> European Commission (2014), 'Commission Regulation (EU) No 176/2014 of 25 February 2014', available at: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.056.01.0011.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.056.01.0011.01.ENG).

<sup>17</sup> European Commission (2014), 'A Policy Framework for Climate and Energy in the Period from 2020 to 2030', COM(2014) 15 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014DC0015>.

called back-loading a significant step forward but also stated that more reforms were needed in order to bring the EU ETS in line with this new 2030 target. The principal amendment is that the **annual reduction of the cap** for EU ETS emissions will have to increase **from 1.74% to 2.2%** starting in 2021, the start of Phase IV.

Moreover, the EC did not deem the expected increased annual reduction in the cap sufficient in itself to address the negative implications of the severe market imbalance, namely the long-lasting and structural nature of the accumulated surplus. It expects that the surplus will only gradually be reduced.<sup>18</sup> It also believes that merely increasing the annual reduction in the cap will not protect the system against further unexpected demand-side shocks resulting from macroeconomic changes and/or complementary policies, nor from supply-side risks such as the inflow of international credits. Therefore, also in January 2014, the EC published a separate proposal for the establishment of a **Market Stability Reserve (MSR)** in 2021 as part of the 2030 Framework.<sup>19</sup> The main purpose of this instrument is to make the supply side more flexible so that it is better able to respond to demand side fluctuations. Following this publication and the implementation of back-loading in February 2014, the price of CO<sub>2</sub> increased from around €5/tCO<sub>2</sub> to €7/tCO<sub>2</sub> between January and February 2014, see Figure 3, only to lose this gain again by May 2014.

The **European Council of October 2014** endorsed the 2030 Framework and with it the new GHG emissions reduction targets for 2030.<sup>20</sup> Included in its conclusions were several very specific conditions for the future Phase IV reforms of the EU ETS, necessary to get all the EU Member States on board, including those that are more sceptical of strong commitments.

- **Free allocation** of allowances is to continue after 2020 in order to prevent **carbon leakage**.<sup>21</sup>
- **Solidarity measures** are to remain present. For countries with a GDP/capita below 60% of the EU average, this includes the possibility of distributing free allowances to the **energy sector**.
- A new reserve of 2% of the EU ETS allowances is to be set aside to address particularly high additional investment needs in the same category of Member States.
- Furthermore, 10% of the EUAs to be auctioned will be distributed among those countries whose GDP/capita does not exceed 90% of the EU average.

<sup>18</sup> European Commission (2014), 'Questions and Answers on the Proposed Market Stability Reserve for the EU Emissions Trading System', available at: [http://europa.eu/rapid/press-release\\_MEMO-14-39\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-39_en.htm).

<sup>19</sup> European Commission (2014), 'Concerning the Establishment and Operation of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Amending Directive 2003/87/EC', COM(2014) 20 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:0020:FIN>.

<sup>20</sup> European Council (2014), 'Conclusions 23 and 24 October 2014', available at: <http://data.consilium.europa.eu/doc/document/ST-169-2014-INIT/en/pdf>.

<sup>21</sup> Carbon leakage is the term often used to describe the situation that may occur if, for reasons of costs related to climate policies, businesses were to transfer production to other countries which have laxer constraints on greenhouse gas emissions. This could lead to an increase in their total emissions. The risk of carbon leakage may be higher in certain energy-intensive industries. See: European Commission (2015), 'Carbon Leakage', [http://ec.europa.eu/clima/policies/ets/cap/leakage/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/cap/leakage/index_en.htm).

- Also, the NER 300<sup>22</sup> facility should be renewed, including for carbon capture and storage and renewables, and its scope extended to low-carbon innovation in industrial sectors. The initial endowment is to be increased to 400 million allowances. The distribution of funds is to be based on a combination of verified emissions and GDP per capita criteria among all Member States, including small-scale projects.

On **25 February 2015** the EC published its plans for an **Energy Union**, attempting to consolidate energy and climate policy into one overall energy and climate strategy.<sup>23</sup> One of the five main pillars is the decarbonisation of the economy, in which the EU ETS plays an important role as the pillar of EU climate policy. This is also the case for the EU's GHG emissions pledge for the COP21 in Paris in December 2015. In the Energy Union plans the EC calls for a well-functioning EU ETS that includes the Market Stability Reserve and the 2030 Framework. In the Roadmap for the Energy Union, the EC pledged to publish a legislative proposal to revise the EU ETS so that it is in line with the 2030 Framework.<sup>24</sup> Before finally publishing its proposal for Phase IV on 15 July 2015, consensus was first reached on the details for the establishment of a Market Stability Reserve.

## The Market Stability Reserve

As mentioned above, as part of its 2030 Framework proposals the EC published a separate proposal in January 2014 for the establishment of a **Market Stability Reserve** to address the magnitude of the oversupply.<sup>25</sup> In this system, allowances are to be placed in, and released from, a reserve when the surplus in the carbon market extends beyond a predefined range. The overall purpose of the MRS is to ensure that the size of the surplus will be significantly reduced and that the whole system will be better protected against future demand-side shocks. The possibility of allowances being taken from the reserve and put back into the market means that **the EC does not consider the mere existence of a surplus a problem** per se; it is the fact that it now equals a years' worth of demand which imbalances the entire system.

For allowances to be added to the reserve, the surplus will have to be greater than 833 million. Similarly, for allowances to be moved from the reserve back into the market – on the condition that the reserve contains allowances at all – the surplus

<sup>22</sup> The aim of the NER 300 programme is to establish a demonstration programme comprising the best possible CCS and RES projects and involving all Member States. NER 300 is thus called because it is funded from the sale of 300 million EUAs from the New Entrants' Reserve (NER) set up for Phase III. This NER was established for new installations and installations that increase their capacity during the third trading period. Initially, it held 480.2 million EUAs. See: [http://ec.europa.eu/clima/news/articles/news\\_2015072301\\_en.htm](http://ec.europa.eu/clima/news/articles/news_2015072301_en.htm) and [http://ec.europa.eu/clima/policies/lowcarbon/ner300/index\\_en.htm](http://ec.europa.eu/clima/policies/lowcarbon/ner300/index_en.htm).

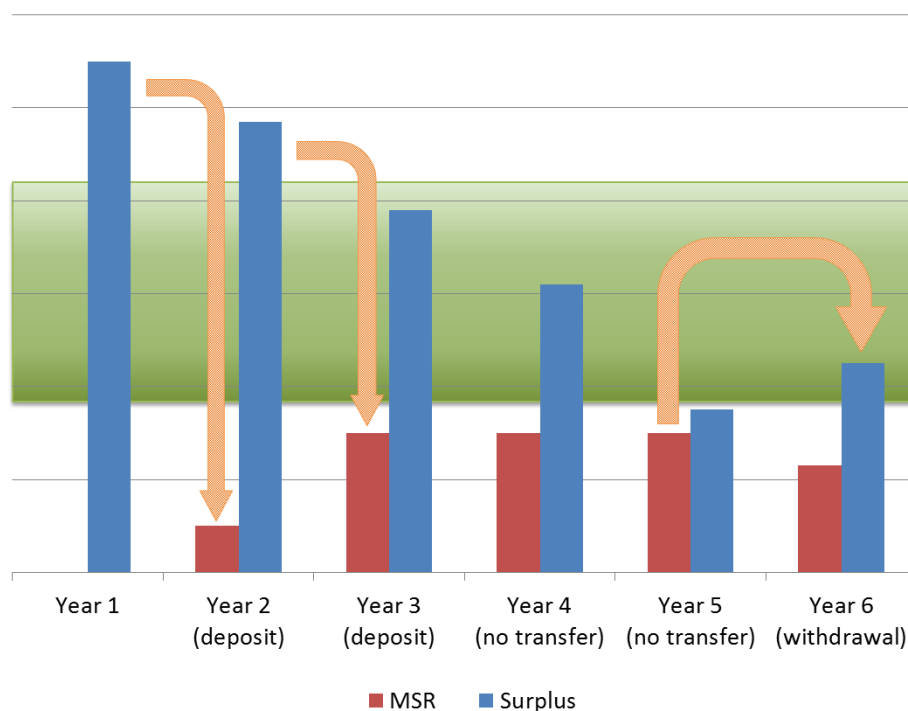
<sup>23</sup> European Commission (2015), 'Energy Union Package – A Framework for a Resilient Energy Union with a Forward-Looking Climate Change Policy', COM(2015) 80 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2015:80:FIN>.

<sup>24</sup> Ibidem.

<sup>25</sup> European Commission (2014), 'Concerning the Establishment and Operation of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Amending Directive 2003/87/EC', COM(2014) 20 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:0020:FIN>.



will have to fall below 400 million allowances. When the surplus is within these two boundaries, no supply-side adjustments will take place.<sup>26</sup> For comparison: today, the surplus stands at over two billion allowances. Figure 4 provides a simplified visualisation of how the Market Stability Reserve could work in practice.



**Figure 4. Simplified visualisation of how the Market Stability Reserve could work in practice. The words between brackets refer to possible transfers taking place between the MSR and the carbon market in a given year, based on the size of the surplus in the preceding year. The shaded green square indicates the range of 400 million to 833 million between which no transfers are to take place between the market and the reserve. This illustration refers to a hypothetical situation and merely serves to explain the interaction between the market and the reserve.<sup>27</sup>**

Following long negotiations, on **13 May 2015** the European Parliament (EP) and the European Council, with the EC's approval, reached a **compromise** on the specifics of this system<sup>28</sup>:

<sup>26</sup> European Parliament and European Council (2015), 'Decision of the European Parliament and of the Council Concerning the Establishment of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Amending Directive 2003/87/EC', available at: [http://www.europarl.europa.eu/meetdocs/2014\\_2019/documents/envi/dv/ets\\_msr\\_annex\\_/ets\\_msr\\_annex\\_en.pdf](http://www.europarl.europa.eu/meetdocs/2014_2019/documents/envi/dv/ets_msr_annex_/ets_msr_annex_en.pdf). The only other option to trigger a release of allowances from the MSR back into the market is Article 29a of Directive 2003/87/EC which sets out measures in the event of excessive price fluctuations.

<sup>27</sup> There are rules applicable as regard to the size of the deposits and withdrawals to take place. See the agreement between the European Parliament and European Council for the specifics.

<sup>28</sup> European Parliament and European Council (2015), 'Decision of the European Parliament and of the Council of – concerning the establishment of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC', available at: [http://www.europarl.europa.eu/meetdocs/2014\\_2019/documents/envi/dv/ets\\_msr\\_annex\\_/ets\\_msr\\_annex\\_en.pdf](http://www.europarl.europa.eu/meetdocs/2014_2019/documents/envi/dv/ets_msr_annex_/ets_msr_annex_en.pdf).

- The MSR will be established in 2018 and will be operational as of 1 January 2019;
- The 900 million back-loaded allowances will be placed into the reserve instead of returning to the market in 2019 and 2020;
- Unallocated allowances<sup>29</sup> for Phase III will be placed in the reserve as well at the end of the trading period (2020). Options for further actions with these allowances are left to the EC's discretion. For example, the EP and European Council ask that the EC considers using 50 million of them for Carbon Capture and Storage (CCS) demonstration projects and low-carbon industrial innovation projects;
- The decision for the withdrawal or deposit of allowances will be based on data from the **preceding year**;
- Until 2025 the 'solidarity measures'<sup>30</sup> will not be used to calculate Member States' contributions to the MSR when the size of the surplus calls for a deposit of allowances into the reserve, thereby softening the MSR's impact on the EU's poorer Member States;
- The first review of the MSR is to take place after three years, thereafter at five-year intervals, taking into account its impact on growth, jobs, the European Union's industrial competitiveness and the risk of carbon leakage.

To provide some insights into the positions of the various stakeholders, the main points of discussion will be briefly discussed below.

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<sup>29</sup> Unallocated allowances are allowances which were initially earmarked for free allocation but were not allocated due to closures of companies or reductions in production. Without any intervention, they will be released to the market at the end of Phase III, thereby contributing to a greater surplus. See: European Commission (2015), 'Questions and Answers on the Proposal to Revise the EU Emissions Trading System (EU ETS)', [http://europa.eu/rapid/press-release\\_MEMO-15-5352\\_en.htm#\\_ftn3](http://europa.eu/rapid/press-release_MEMO-15-5352_en.htm#_ftn3).

<sup>30</sup> This refers to the 10% of EUAs destined for Member States with a GDP/capita below 90% of the EU average in 2013, as demanded in the European Council of October 2014's conclusions.

## Points of discussion

The EC's original proposal advocated that the Market Stability Reserve adopt 2021 as its **start date**, the first year of Phase IV.<sup>31</sup> Nonetheless, the EP, through its Environment Committee,<sup>32</sup> advocated a start date of 31 December 2018,<sup>33</sup> while a group of more than 60 **European businesses and associations** in the energy sector had already called for the EP to adopt an even earlier start date in 2017, as was done by the United Kingdom, Germany, the Netherlands, Sweden, Denmark, Slovenia, Luxembourg, Malta and Norway in a joint ministerial statement.<sup>34</sup> Their main argument was that waiting until 2021 would risk postponing critical low-carbon investments that are already needed this decade, thereby increasing decarbonisation costs in the long term. In the **European Council**, a Poland-led blocking minority<sup>35</sup> wanted to stick to the original proposed start date of 2021, fearing that an earlier start date would incur significant extra costs.<sup>36</sup>

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<sup>31</sup> European Commission (2014), 'Concerning the Establishment and Operation of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Amending Directive 2003/87/EC', COM(2014) 20 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:0020:FIN>.

<sup>32</sup> Surprisingly, in January 2015 the European Parliament's (EP) Industry, Research and Energy Committee had voted to abandon its own report due to internal divisions. This report should have represented the Committee's opinion on the MSR but instead left the EP's Environment Committee with the power to decide to start negotiations with the European Council on its own, possibly resulting in a tougher stance from the EP than would have otherwise been the case. To obtain full approval, a plenary vote in the EP was still necessary after talks with the European Council were done. This was done in June 2015. See: EUobserver (2015), 'Industry Committee 'Silenced' Itself on EU Carbon Rules' and European Parliament (2015), 'Parliament Adopts CO<sub>2</sub> Market Stability Reserve', available at:

<http://www.europarl.europa.eu/news/nl/news-room/content/20150703IPR73913/html/Parliament-adopts-CO2-market-stability-reserve>.

<sup>33</sup> European Parliament (2015), 'Environment Committee Backs ETS Market Reserve, Advocates Early Start'.

<sup>34</sup> Joint letter to the European Parliament (24 February 2015), available at:

[http://www.changepartnership.org/wp-content/uploads/2014/10/FINAL\\_Businessletter\\_MSR1.pdf](http://www.changepartnership.org/wp-content/uploads/2014/10/FINAL_Businessletter_MSR1.pdf), and Joint Ministerial Statement on the Market Stability Reserve (February 2015), available at:

<http://www.rijksoverheid.nl/documenten-en-publicaties/rapporten/2015/02/27/joint-ministerial-statement-on-the-market-stability-reserve.html>. Norway is a participant in the EU ETS but does not hold a vote in the European Council because it is not an EU Member State.

<sup>35</sup> Within the European Council, a traditional East-West divide was present, with a Poland-led group of Member States forming a blocking minority, including e.g. the Czech Republic, Hungary, Romania and Cyprus. After starting negotiations with the EP in March, the blocking minority was broken in April 2015 when the Czech Republic 'defected' to the other side in exchange for concessions related to solidarity measures. This opened the way for a common position of the European Council which was to be very much in line with the EP's Environment Committee's stance, eventually leading to the final agreement on the details of the Market Stability Reserve. This agreement was later approved by the European Council as a whole in September 2015. See: Politico (2015), 'Conflict Over When ETS Reform Should Start', European Council (2015), 'Market Stability Reserve: Council Ready to Negotiate with the European Parliament', EurActiv (2015), 'Czechs Paving Way Towards Carbon Market Reform', Carbon Pulse (2015), 'Main Takeaways from EU Council's MSR Deal', and Council of the European Union (2015), 'Greenhouse Gas Emissions: Creation of a Market Stability Reserve Approved', available at: <http://www.consilium.europa.eu/en/press/press-releases/2015/09/18-greenhouse-gas-emissions-creation-of-market-stability-reserve-approved/>.

<sup>36</sup> EurActiv (2015), 'Poland Says Allowances, Not Reforms Start Date, Focus of Carbon Talks'.

Initially, another point of disagreement was the question on what to do with the **back-loaded allowances**. Later on, due to some parties advocating an earlier start date, the **unallocated allowances** for Phase III also became a topic of discussion. The EC's original proposal for a Market Stability Reserve referred to the back-loaded allowances as a short-term measure but saw them as an intervention separate from the implementation of a Market Stability Reserve.<sup>37</sup> The EP, however, advocated for the back-loaded allowances to be placed into the reserve,<sup>38</sup> which was also proposed by the aforementioned group of European businesses and associations.<sup>39</sup> Letting the allowances return to the market would, according to them, only aggravate the surplus problem. Individual associations such as Eurogas had also warned for similar risks posed by the unallocated allowances in Phase III, calling for them to be placed into the reserve as well.<sup>40</sup> Individual countries such as the United Kingdom, Germany and the Netherlands also called for the back-loaded allowances to be placed into the reserve.<sup>41</sup> On the other hand, the countries forming the blocking minority in the European Council preferred to leave both the back-loaded and the unallocated allowances untouched; placing them into the reserve was deemed too disruptive to the carbon market.<sup>42</sup>

Other points of discussion were the year that should be used as a reference to determine the withdrawal or deposit of allowances (**the response time**) and the timing of **a review of the system**. The EC's original proposal called for allowances to be deposited with a response time of two years: in any given year, the size of the surplus two years earlier would determine whether allowances should be deposited into the reserve. For withdrawals from the reserve a response time of only one year was to be used. A review of the functioning of the Market Stability Reserve was to take place five years after implementation. Parties such as the EP, Eurogas and the Netherlands advocated a shorter response time for allowances to be released from

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<sup>37</sup> European Commission (2014), 'Concerning the Establishment and Operation of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Amending Directive 2003/87/EC', COM(2014) 20 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:0020:FIN>.

<sup>38</sup> European Parliament (2015), 'Environment Committee Backs ETS Market Reserve, Advocates Early Start'.

<sup>39</sup> Joint letter to the European Parliament (24 February 2015), available at: [http://www.changepartnership.org/wp-content/uploads/2014/10/FINAL\\_Businessletter\\_MSR1.pdf](http://www.changepartnership.org/wp-content/uploads/2014/10/FINAL_Businessletter_MSR1.pdf).

<sup>40</sup> Eurogas (2015), 'Position Paper. Unallocated Allowances in the Emissions Trading System', available at: <http://www.eurogas.org/uploads/media/2015-Apr - 15PP189 - Eurogas Position Paper on Unallocated Allowances in the Emissions Trading System.pdf>.

<sup>41</sup> United Kingdom (2014), 'UK's Position on the European Commission's Proposal to Reform the EU ETS by Introducing a Market Stability Reserve', available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/364992/UK\\_MSR\\_position\\_gov.uk.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364992/UK_MSR_position_gov.uk.pdf), Germany (2014), 'Deutsche Stellungnahme zum Kommissionsvorschlag zur Einführung einer Marktstabilitätsreserve zur Reform des EU-Emissionshandels', available at: <http://www.bmub.bund.de/themen/klima-energie/emissionshandel/stellungnahme-reform-eu-emissionshandel/>, and The Netherlands (2014), 'Kamerbrief over het Europese emissiehandelssysteem voor CO<sub>2</sub>', available at: <http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2014/12/09/het-europese-emissiehandelssysteem-voor-co2.html>.

<sup>42</sup> EurActiv (2015), 'Poland Says Allowances, Not Reforms Start Date, Focus of Carbon Talks'.

the reserve, and an earlier review of the system was also deemed necessary.<sup>43</sup> Overall, those parties in favour of a shorter response time and earlier review claimed that such adjustments were needed to ensure the proper functioning of the reserve.

In their amendments to the EC's original MSR proposal, the European Council and the EP also stated that the EC should make a proposal to **review the EU ETS's Directive** for Phase IV within six months of their agreement. In compliance with that demand, as part of its **Energy Union Summer Package**, the EC published a proposal in July 2015 to revise the system for its fourth phase.

### Phase IV reforms<sup>44</sup>

To align the EU ETS with the new 43% GHG emissions reduction target for 2030, the EC published a legislative proposal on **15 July 2015** to reform the EU ETS for Phase IV (2021-2030). The main instrument will be an increase of the **annual reduction in the EU ETS cap** from 1.74% (Phase III) to **2.2%**. Also, the **auction share** of EU ETS allowances, as opposed to their free allocation, is to be fixed at 57% for all of Phase IV. In complying with their targets, Member States will no longer be able to use **international credits** in Phase IV.

The conditions set by the European Council of October 2014 when it endorsed the 2030 Framework and the new GHG emissions reduction target of 43% for 2030 are taken into account.<sup>45</sup> This is visible in the **continued free allocation** to prevent carbon leakage,<sup>46</sup> **solidarity measures** to aid poorer Member States,<sup>47</sup> the

<sup>43</sup> European Parliament (2015), 'Environment Committee Backs ETS Market Reserve, Advocates Early Start', Eurogas (2014), 'Position Paper. Eurogas Views on the EU Emissions Trading System and the Market Stability Reserve', available at: [http://www.eurogas.org/uploads/media/14PP396\\_Eurogas\\_views\\_on\\_the\\_ETS\\_and\\_Market\\_Stability\\_Reserve.pdf](http://www.eurogas.org/uploads/media/14PP396_Eurogas_views_on_the_ETS_and_Market_Stability_Reserve.pdf), and The Netherlands (2014), 'Kamerbrief over het Europese emissiehandelssysteem voor CO<sub>2</sub>', available at: <http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2014/12/09/het-europese-emissiehandelssysteem-voor-co2.html>.

<sup>44</sup> The rest of this section, unless specified otherwise, uses the following source: European Commission (2015), 'Proposal for a Directive of the European Parliament and of the Council Amending Directive 2003/87/EC to Enhance Cost-effective Emission Reductions and Low-carbon Investments', COM(2015) 337 final, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2015:337:REV1>.

<sup>45</sup> European Council (2014), 'Conclusions 23 and 24 October 2014', available at: <http://data.consilium.europa.eu/doc/document/ST-169-2014-INIT/en/pdf>.

<sup>46</sup> Free allocation will amount to 43% of all EUAs in Phase IV, mainly serving to address direct costs related to carbon, but Member States are also encouraged to use auction revenues to address indirect costs such as higher electricity prices for electricity intensive industries. Free allocation is going to be more stringent in Phase IV as compared to Phase III. More frequent alignment of the free allocation to production data will take place, first in 2021 and later in 2026. In Phase III pre-economic crisis data is being used for the entirety of the Phase until 2020.

<sup>47</sup> The so-called **solidarity measures**, present in Phase III and demanded for Phase IV by the European Council of October 2014, will be maintained. The first stipulates that 10% of the EUAs to be auctioned will be distributed among those countries whose GDP/capita does not exceed 90% of the EU average in 2013, thereby increasing the total number of allowances to be auctioned by these Member States. Compared to Phase III, the number of Member States eligible for this stimulus for Phase IV will decrease from 20 to 15, resulting in Belgium, Croatia, Italy, Luxembourg, and Sweden to be taken off the list. The second solidarity measure is the continued free allocation to installations for electricity production during Phase IV for Member

establishment of a **Modernisation Fund**<sup>48</sup> and an **Innovation Fund**,<sup>49</sup> and the renewal and increase of the NER 300 facility.<sup>50</sup>

Reception of the proposal has been mixed so far, with no party apparently fully content. Industry indicates that carbon leakage provisions are not sufficient, while at the same time environmental groups see the EC's proposal as a big concession to industrial lobbying.<sup>51</sup> What surprised many observers is that the EC proposes **using allowances previously destined for the Market Stability Reserve**; it was generally thought that these were to remain there so as to shrink the surplus currently present in the system. The final provision in the MSR agreement between the European Council and the EP for the EC to 'submit a proposal to the European Parliament and to the Council on options for further action [on the unallocated allowances]'<sup>52</sup> was apparently interpreted as being a mere formality, or perhaps the scale of it was thought to be smaller than the current 300 million proposed by the EC (250 million for the NER and 50 million for the Innovation Fund).

In February 2016, the EP's Environment Committee met for its first formal hearing on the EC's Phase IV proposal. Several topics were discussed including its ambition in light of the COP21 agreement in Paris of December 2015, industrial competitiveness concerns regarding future carbon costs, free-allocation of allowances, as well as the scope of the entire system regarding the sectors it covers.<sup>53</sup>

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States which had a GDP/capita below 60% of the EU average in 2013. This is called the 'transitional free allocation' and serves to modernise these countries' electricity sectors and diversify their energy mixes.

<sup>48</sup> The Modernisation Fund can also be considered a solidarity measure, as it will be established to support investments in modernising energy systems and improving energy efficiency in Member States that had a GDP/capita below 60% of the EU average in 2013. This fund will consist of 2% of the total EUAs, or 310 million allowances. The distribution of funds will be based on a combination of verified emissions and GDP/capita criteria.

<sup>49</sup> An Innovation Fund will be set up to support first-of-a-kind investments in renewable energy, CCS and low-carbon innovation in energy-intensive industry. For this purpose 400 million allowances will be set aside from Phase IV. Added to this will be 50 million unallocated allowances from Phase III in order to support projects prior to 2021. These 50 million allowances are part of the unallocated allowances from Phase III destined for the Market Stability Reserve, as determined by the agreement between the European Parliament and European Council. In that same agreement both parties asked the European Commission to look into options to use 50 million of those allowances for CCS demonstration projects and low-carbon industrial innovation projects.

<sup>50</sup> Phase IV will also have a New Entrants' Reserve (NER) similar to Phase III. This reserve will contain allowances set aside for new entrants (companies) to the market and significant production increases. In Phase IV this amount will be supplemented by 250 million allowances previously placed in the Market Stability Reserve. Contrary to Phase III, free allocation of allowances for **production increases** not resulting from newly-built production capacity will also be provided for. This should provide companies with idle capacity as a result of the prolonged economic crisis more room to grow.

<sup>51</sup> Carbon Pulse (2015), 'Takeaways and Reactions to the post-2020 EU ETS reform proposals'.

<sup>52</sup> European Parliament and European Council (2015), 'Decision of the European Parliament and of the Council Concerning the Establishment of a Market Stability Reserve for the Union Greenhouse Gas Emission Trading Scheme and Amending Directive 2003/87/EC', available at: [http://www.europarl.europa.eu/meetdocs/2014\\_2019/documents/envi/dv/ets\\_msr\\_annex\\_ets\\_msr\\_annex\\_en.pdf](http://www.europarl.europa.eu/meetdocs/2014_2019/documents/envi/dv/ets_msr_annex_ets_msr_annex_en.pdf).

<sup>53</sup> Carbon Pulse (2016), 'Five Things we learned from MEPs' First Look at EU ETS Reform Plans'.

## Comments

If previous experiences with regard to the MSR discussions are exemplary of the time necessary to reach a final agreement on the Phase IV reforms, it will take close to two years before this is accomplished. A final deal is therefore not expected before 2017.<sup>54</sup> In the meantime, several developments have taken place in EU Member States in the absence of a clear carbon price signal from the EU ETS.

The UK introduced a carbon price floor in 2013 for power generators and CHP stations. It was initially set at £16/tCO<sub>2</sub> and was planned to increase to £30/tCO<sub>2</sub> (2020) and £70/tCO<sub>2</sub> (2030) in 2009 prices.<sup>55</sup> France introduced a carbon tax in 2014 on the use of gas, heavy fuel oil and coal, set at €14.5/tCO<sub>2</sub> for 2015 and €22/tCO<sub>2</sub> for 2016. This applies to the final consumption in transport and heating, sectors not directly covered by the EU ETS. Moreover, as part of the country's new energy transition law for green growth, France expressed its plans to increase this tax to €56/tCO<sub>2</sub> by 2020, before moving to €100/tCO<sub>2</sub> by 2030.<sup>56</sup> Germany attempted to introduce a Climate Levy on the oldest and most polluting coal power plants but abandoned these plans in July 2015 following strong protests from industry and coal-mining *Bundesländern*.<sup>57</sup> Nonetheless, it reflected a desire by the German government to align the country's GHG emissions with its domestic GHG emissions reduction target as part of its energy transition, the *Energiewende*.<sup>58</sup> Member States are not the only ones to aim to put a (higher) price on carbon; in June this year major oil and gas companies (BG Group, BP, Eni, Shell, Statoil and Total) called for governments around the world and the United Nations Framework Convention on

<sup>54</sup> Energy Post (2015), 'EU Kicks Off Final Phase of Controversial Carbon Market Reform'.

<sup>55</sup> The Carbon Price Floor is the intended lower threshold of the carbon price and is set by the UK government. Two elements concur to realising it: the EU ETS and the Carbon Price Support (a carbon tax) on top of it. The Carbon Price Support itself is set three years in advance based on the EU ETS at the time. It therefore serves the purpose of filling the gap between the EU ETS and the Carbon Price Floor targeted by the UK government. By imposing a Carbon Price Floor, the UK intends to encourage investment in low-carbon electricity generation so as to decarbonise the electricity sector. Due to the current low price of EUAs in the EU ETS, the UK government decided in March 2014 to cap the Carbon Price Support at £18/tCO<sub>2</sub> until March 2020. This was done to limit the difference in carbon prices between the UK and the rest of Europe. See: Sandbag (2015), 'Carbon Price Instruments for the Power Sector', available at: [https://sandbag.org.uk/site\\_media/pdfs/reports/Comparing\\_carbon\\_price\\_instruments.pdf](https://sandbag.org.uk/site_media/pdfs/reports/Comparing_carbon_price_instruments.pdf), and United Kingdom (2011), 'Government Publishes Response to Carbon Price Floor Consultation', <https://www.gov.uk/government/news/government-publishes-response-to-carbon-price-floor-consultation>.

<sup>56</sup> France (2015), 'LOI n° 2015-992 du 17 août 2015 relative à la transition énergétique pour la croissance verte', available at: <http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000031044385&categorieLien=id>, and A. Rüdinger (2015), 'The French Energy Transition Law for Green Growth: At the limits of governance by objectives', available at: [http://www.iddri.org/Publications/Collections/Syntheses/IB0715\\_AR\\_FETL.pdf](http://www.iddri.org/Publications/Collections/Syntheses/IB0715_AR_FETL.pdf).

<sup>57</sup> Bundesministerium für Wirtschaft und Energie (2015), 'Eckpunkte für eine erfolgreiche Umsetzung der Energiewende', available at: <https://www.bmwi.de/BMWi/Redaktion/PDF/E/eckpunkte-energiewende,property=pdf,bereich=bmwi2012,sprache=de,rwb=true.pdf>.

<sup>58</sup> Bundesministerium für Umwelt, Naturschutz, Bau und Reaktorsicherheit (2014), 'Aktionsprogramm Klimaschutz 2020', available at: [http://www.bmub.bund.de/fileadmin/Daten\\_BMU/Download\\_PDF/Aktionsprogramm\\_Klimaschutz/aktionsprogramm\\_klimaschutz\\_2020\\_broschuere\\_bf.pdf](http://www.bmub.bund.de/fileadmin/Daten_BMU/Download_PDF/Aktionsprogramm_Klimaschutz/aktionsprogramm_klimaschutz_2020_broschuere_bf.pdf).

Climate Change to introduce a carbon pricing system.<sup>59</sup> An increasing number of companies are putting a price on their carbon pollution, a voluntary measure used as a financial planning tool. These internal carbon prices are often considerably higher than the current level of the EU ETS, possibly reflecting the expectation of more stringent climate efforts in the future.<sup>60</sup>

If the EU ETS is to be the flagship of the EU's future climate policy, and if it is to provide enough stimulus for the low-carbon investments necessary to achieve the decarbonisation of the European economies in a cost-effective manner, a break with the past is necessary. The exact form of Phase IV remains to be seen. The saying 'the devil is in the detail' is especially true for the EU ETS.

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<sup>59</sup> Shell (2015), 'Oil and Gas Majors Call for Carbon Pricing', <http://www.shell.com/global/aboutshell/investor/news-and-library/2015/oil-and-gas-majors-call-for-carbon-pricing.html>.

<sup>60</sup> Financial Times (2015), 'Companies Accelerate Use of Carbon Pricing'.





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