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Market Stability Reserve for the EU Emissions Trading System (EU ETS)

Structural Imbalance in the EU ETS

The EU ETS System has been weakened by a structural imbalance of supply and demand of allowances. More than 2 billion allowances have piled up as a surplus between 2011 and 2012. The report on the state of the European carbon market in 2012 showed that without action, the surplus is expected to grow to more than 2.6 billion in 2020. As a result, the European Commission has conducted extensive stakeholder consultations for a structural reform of the EU ETS from December 2012 until February 2013.

Process of Structural Reform of the EU ETS

The carbon market report in 2012 set out six non-exhaustive options for a structural reform of the ETS.[1] Further consultation meetings in March and April 2013 focused on these six measures and possible additional options. The option of a market stability reserve was raised and supported by a majority of involved stakeholders. This led to an expert meeting in October 2013, where technical aspects of a possible market stability reserve were discussed.

In December 2013, the European Parliament and Council approved the 'back-loading' (postponement of the auctioning) of 900 million allowances. However, this measure is only a short-term relief, as it does not reduce the overall amount of allowances to be auctioned in phase 3. Hence, the market imbalance would increase again after all allowances have been released at the end of the third period.

In order to achieve the emissions reduction targets proposed in the 2030 framework, the linear reduction factor of the EU ETS would need to be changed from 1.74% to 2.2%. However, the impact assessment accompanying the 2030 framework showed that raising the linear factor will only be a gradual change and not enough to reduce the structural imbalances in the coming decade.

Proposal for a Market Stability Reserve

As a long-term solution, the European Commission has issued a legislative proposal for the introduction of a market stability reserve as part of its 2030 framework for climate and energy policies. The market stability reserve is proposed to be launched at the beginning of the next trading period in 2021 and is expected to provide better stability and resilience for the carbon market through a mechanism that balances supply and demand: Currently, the EU ETS system fixes the supply of allowances in a rigid manner, although demand is highly flexible due to the impact of economic cycles, fuel prices etc. A market stability reserve takes this into account and allows for a more flexible release of allowances in times of low or strong demand by withholding and releasing allowances for auctioning.

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[1] The following six options were discussed: increasing the EU reduction target to 30% in 2020; retiring a number of allowances in phase 3; early revision of the annual linear reduction factor; extension of the scope of the EU ETS to other sectors; use access to international credits; and discretionary price management mechanisms.

Non-Discretionary Measure for Long-Term Stability

The market stability reserve is proposed as a rule-based process that automatically sets in if certain pre-defined thresholds and conditions are met. Hence, it provides a transparent and clear mechanism that can be easily understood and foreseen by market participants. Whether allowances are placed in the reserve is decided upon by the liquidity factor which is the “total number of allowances in circulation” indicating the number of allowances in the market not needed for compliance needs.[2] This number will be published every year in May. If the total number of allowances in the previous year surpassed 833 million, the maximum amount without reserve activity, 12% of the allowances will be placed in the reserve at the beginning of a year.

A pre-defined volume of allowances placed in the reserve (100 million or all if less is in reserve) will be released if one of the following conditions applies:

1) The total number of allowances in circulation in a given year is below 400 million;
2) The carbon price is more than three times the average price of the two preceding years in six consecutive months (even when the total is more than 400 million).

Next Steps

The proposal for a market stability reserve requires approval by the European Parliament and the Council. If the market stability reserve is implemented, a focused review is planned for 2026.

Further Information

Market Stability Reserve: http://europa.eu/rapid/press-release_MEMO-14-39_en.htm
Structural reform of the European carbon market:
http://ec.europa.eu/clima/policies/ets/reform/index_en.htm

[2] The “total number of allowances in circulation is defined as the following: “difference between all allowances issued and international credits used since 1 January 2009 until end of each year, and verified emissions recorded since 2008 and allowances in the reserve at the end of that same year.”