

Design Parameters of the Planned Market Stability Reserve under the EU Emissions Trading Scheme

European Commission Expert Meeting

» EU ETS Structural Reform: Introduction of a Market Stability Reserve «

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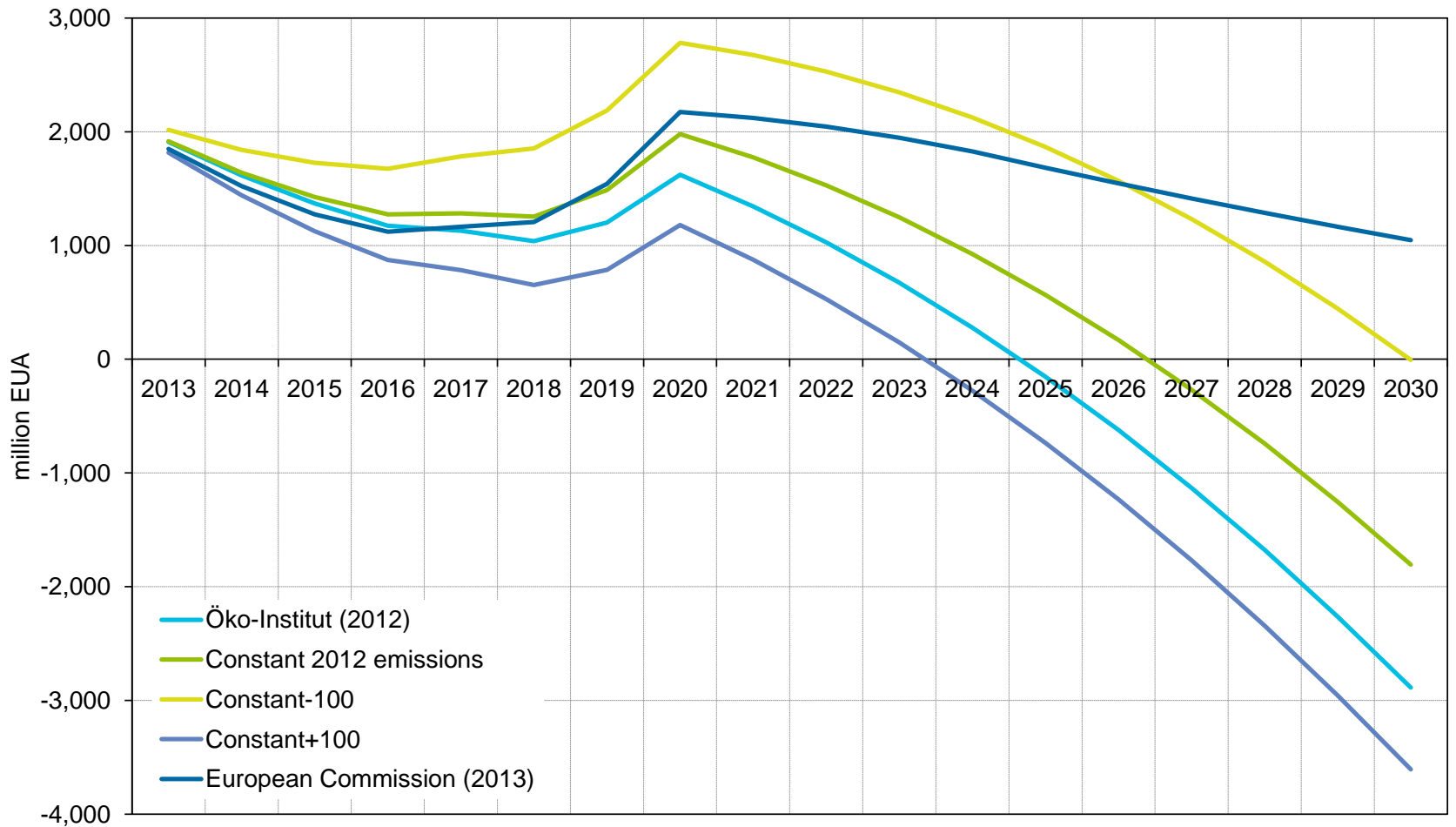
- **Empirical evidence**

- The EU ETS was designed for an robust economic and political environment, this assumption has proven to be not robust
- The sources of uncertainties are essentially twofold (by now)
 - Macroeconomic uncertainties have definitely materialized
 - Policy uncertainties (e.g. complementary policies on energy efficiency or renewables) have (coincidentally) not yet materialized
- Economic and policy uncertainties can create a level of surplus that “contaminates” the EU ETS for extremely long periods of time

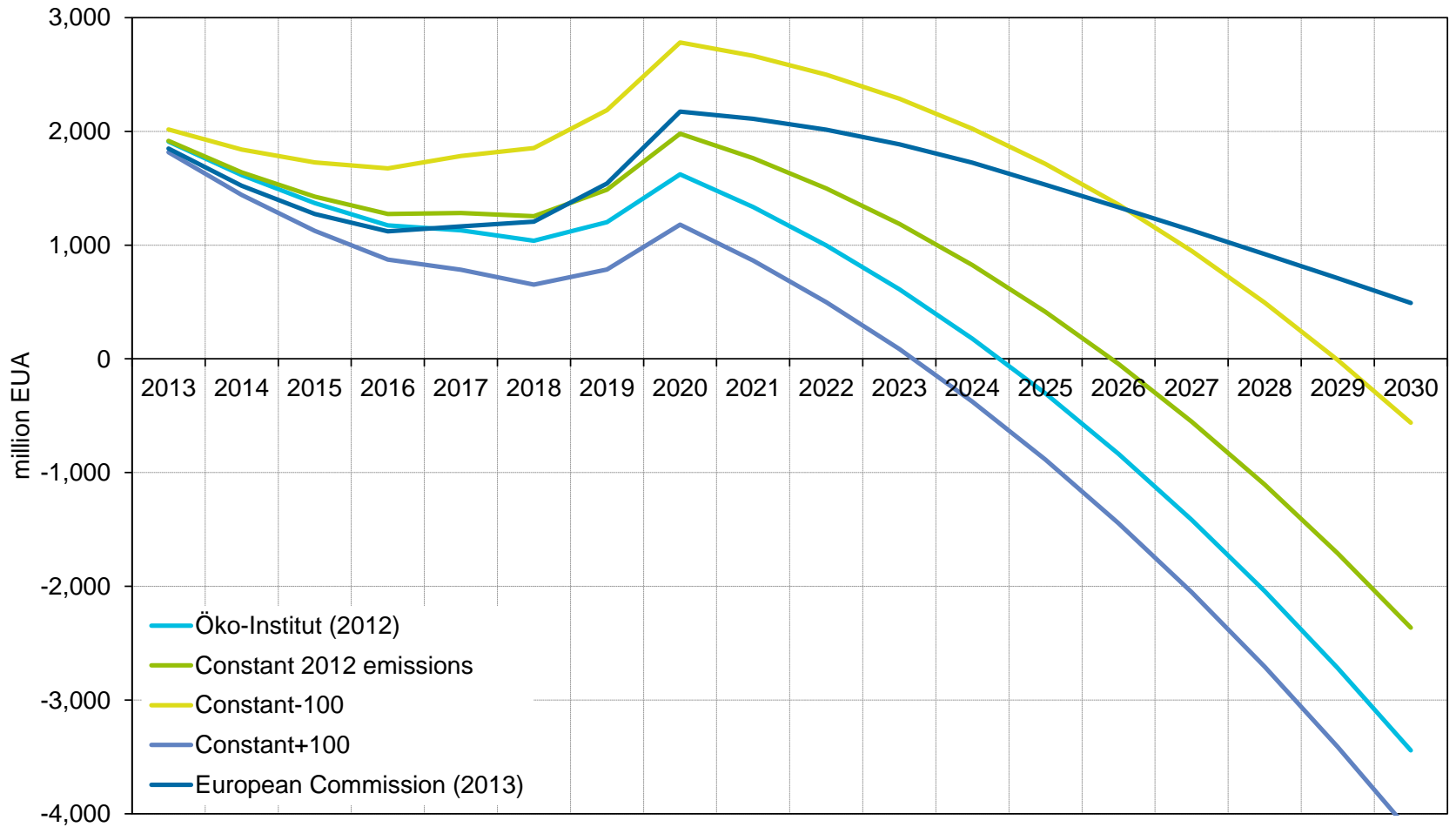
- **The main challenges**

- Will the EU ETS survive as a policy tool which has an impact on investment decisions or will it be emerge as a instrument to safeguard clean dispatch and investments will be controlled by other means?
- The good news: the long-term design (linear contraction of the cap) works at least as a prevention mechanism – from a holistic perspective
- Flexibility mechanisms are needed to avoid (long-term) price volatility

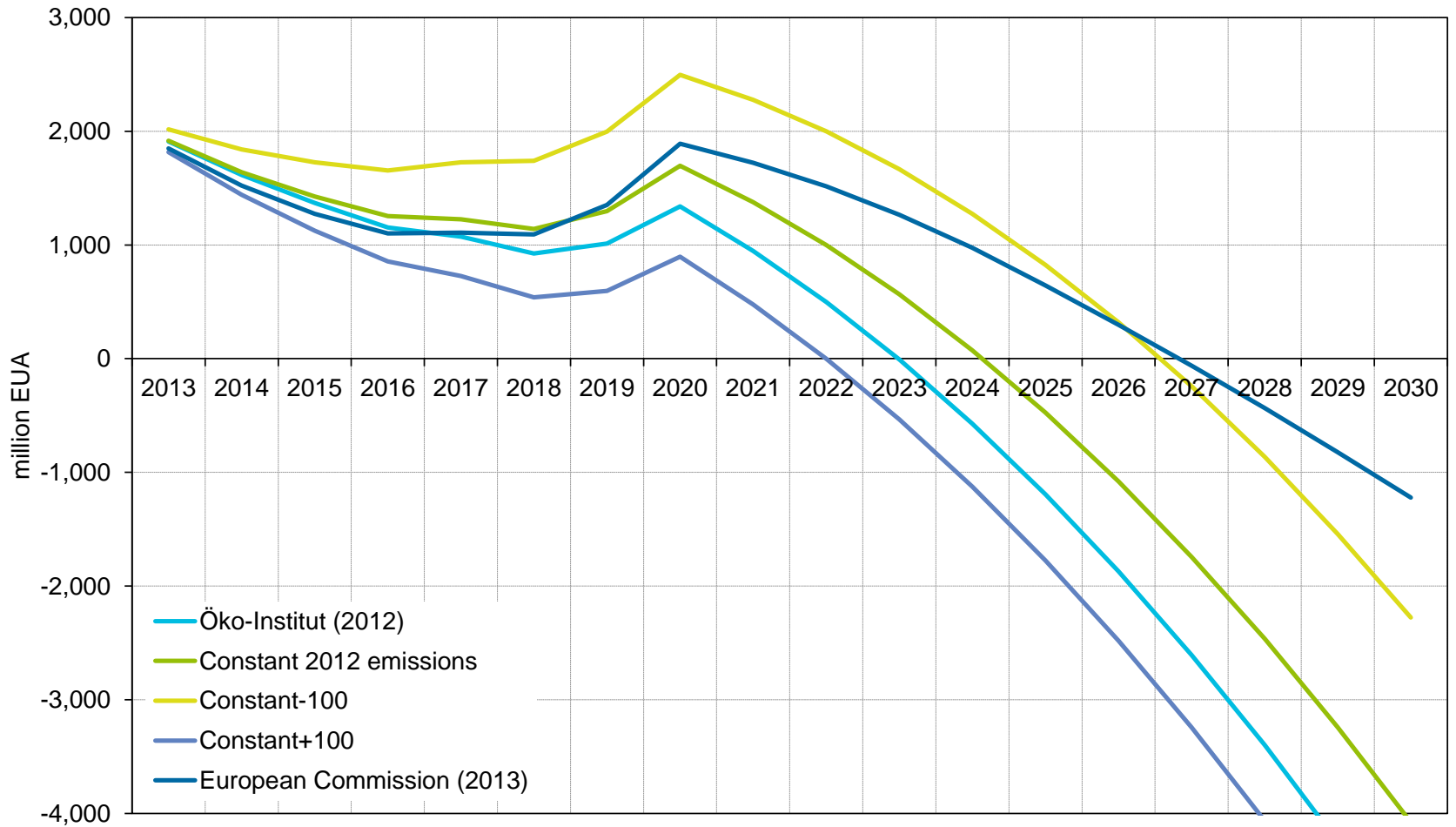
Huge uncertainties on the baseline (counter-factual) emissions as a challenge (LRF 1.74%)



Huge uncertainties on the baseline (counter-factual) emissions as a challenge (LRF 2.2%)



Huge uncertainties on the baseline (counter-factual) emissions as a challenge (LRF 2.6%/2016)



- **The flexibility mechanism relies on the quantity of the surplus (AiC)**
 - The probably best trigger indicator because it delivers the most aggregate information
 - Scarcity pricing is maintained as the basic EU ETS design principle
- **The concept behind the market stability reserve**
 - the power sector relies on conservative hedging strategies: sales and purchases up to three years in advance (almost total annual production is sold in futures markets)
 - hedging creates a demand for physical allowances (no cross-commodity hedging) – even in a surplus situation (long market) scarcity prices will be generated
- **The concept of the MSR is a bet that the hedging corridor idea & parameterization represents reality**
 - In general and at present – evidence needed
 - in future (especially in a lower carbon and/or high renewables world)

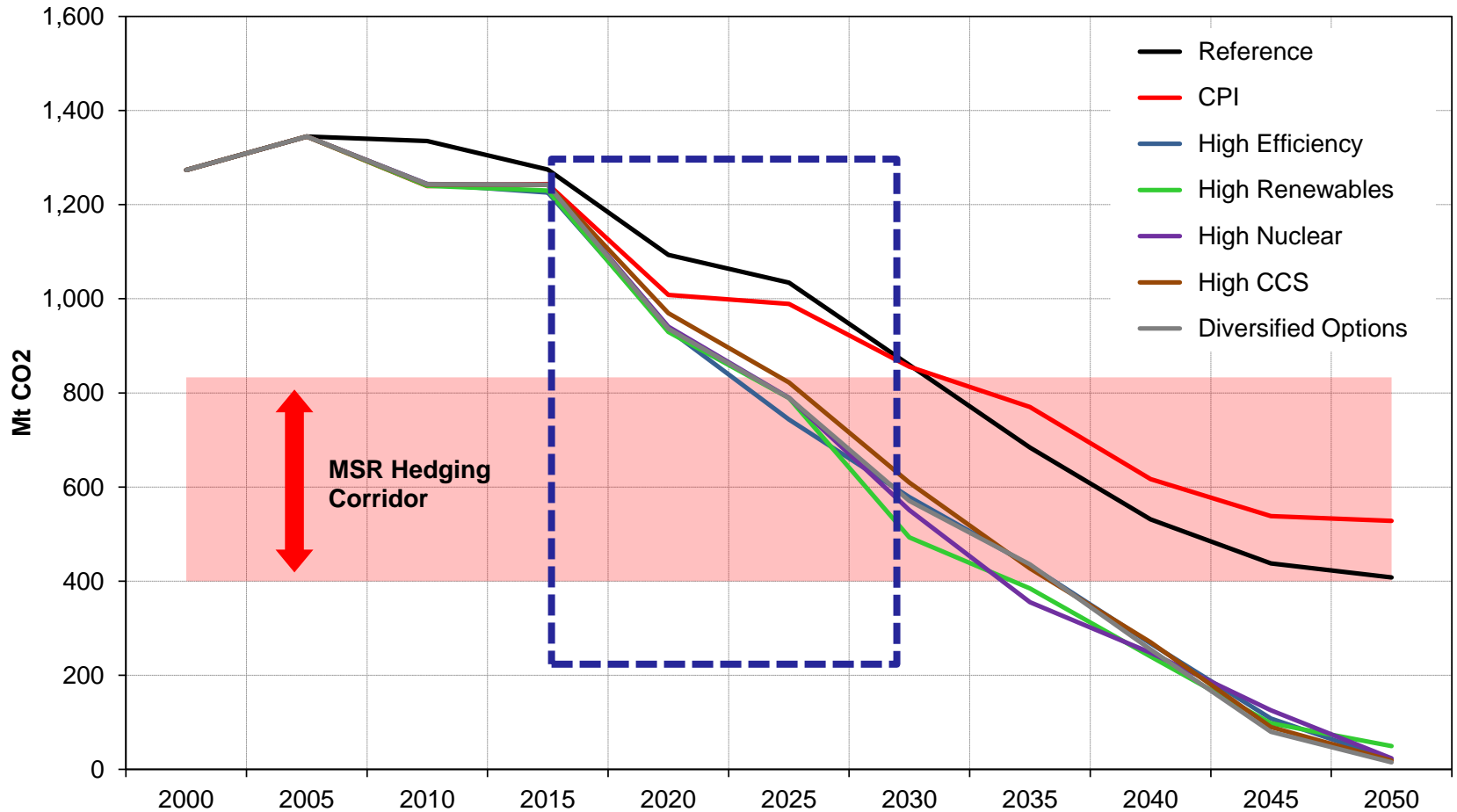
- **Hedging is a reality in the EU power market, hedging strategies are however very different**

	n-3	n-2	n-1	n
Nordic market	20%	25%	25%	30%
UK market	10%	35%	50%	5%
Central-west market	5%	5%	75%	15%
Central-east market	35%	40%	20%	5%
Iborean market	10%	30%	40%	20%

- **Hedging strategies will probably be subject to significant changes**
 - Expansion of variable renewables: more interest in spot markets and shift away from forward contracts!?
 - Emissions reductions will materialize significantly in the power sector
 - Result: Hedging demand for allowances will decrease significantly

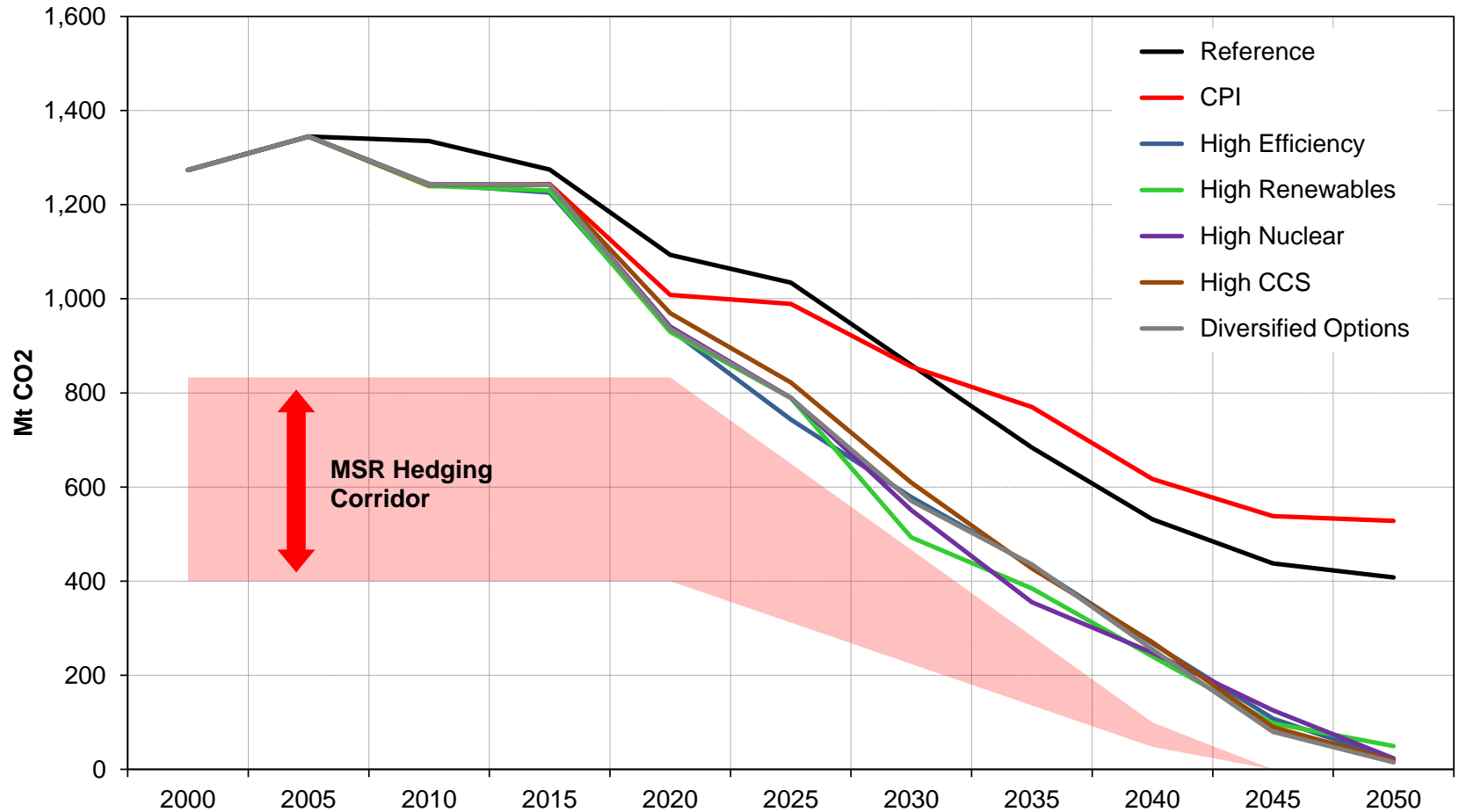
The EU ETS MSR & EU power sector emissions

Parameterization needs to be adjusted



Alternative EU ETS MSR Parameterization

Upper band of HC shrinks at 2 x LRF (2,2%) p.a.



**Thank you
very much**

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