



Expert workshop on the Market Stability Reserve

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ERCST

Roundtable on
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Sustainable Transition

ERCST work on the MSR review

- ERCST started its work on the MSR impact on Phase 4 already in 2018, and organised close to 10 meetings on the MSR and its review over the last years.
- **ERCST paper “Preparing the review of the Market Stability Reserve” was launched in November 2019.**
- In 2020, we continue our work and promote further discussions with stakeholders on MSR’s functioning and its mandated review.

The legal basis for the MSR Review

- **Article 3** of the MSR Decision requires, periodically, an assessment of the MSR functioning, and the delivery of its objectives (reviews scheduled in **2021** and **2026**).
- Art. 3 indicates that **some elements to be included** in the analysis are:
 - i. the MSR intake rate** (*‘the percentage figure for the determination of the number of allowances to be placed in the reserve’*);
 - ii. the continued appropriateness of the upper and lower thresholds** (*‘the numerical value of the threshold’*);
 - iii. and the relationship of the Reserve with competitiveness issues** (*‘impact of the reserve on growth, jobs, the Union's industrial competitiveness and on the risk of carbon leakage’*).
- **However, Art. 3 does not clarify how the analysis should be carried out, nor what the structure of the review should be.**

Aim of ERCST work and this presentation

- Try and put forward practical proposals on how the review should be structured.
- As a starting point, it seems reasonable to assume that **the MSR review should be centred on the reserve's ability to meet its stated goals**, as indicated by the relevant legislation.
- The review should answer the following questions:
 - Any review needs to consider the questions : Is this instrument needed / is this the right instrument ?
 - How is the MSR review articulated with the ETS review and the European Green Deal
 - **Is the MSR delivering upon its goals?**
 - In case the MSR would not be delivering, what are the **reasons behind its under-performance?**
 - What changes are needed?

General approach behind the MSR

- Looking at the broad picture, it can be affirmed that the rationale for having a Market Stability Reserve, as opposed to *potential alternatives*, is to ensure:
 - a) There is an automatic mechanism, rule based/The predictability in market intervention** (i.e. stability of governance) – *as opposed to e.g. an one-off cancellation of the built-up surplus;*
 - b) Automatic adjustments of the volumes in the market**, in order to bring the supply-demand balance within a certain desirable bandwidth, as established by the regulator – *as opposed to adjustments triggered by price levels (e.g. establishing a price floor).*

Two goals of the MSR: addressing historical and new imbalances

- The MSR Decision highlights **2 goals of the MSR:**
 1. *Eliminate the historical structural supply-demand imbalance “within a reasonable amount of time”;*
 2. *Bring the TNAC within range of the MSR thresholds in case of new events, “within a reasonable amount of time”*

Is this good enough?

New events:

- Changes to the regulatory & policy environment from what was anticipated when establishing the instrument & parameters
- Exogenous shocks to the system

One goal of the MSR review: competitiveness concerns

- Additionally, there is a **third goal of the review:**
3. *assessing the impact of the MSR on growth, jobs, and competitiveness*
- The emphasis of the MSR Decision on competitiveness issues points to the fact that this should be evaluated as a key and separate element in the review.
 - This is not to say that the MSR should be seen as the instrument to address each and every implication of the EU ETS on competitiveness, but only that **the review should evaluate if the MSR is having an impact on these “competitiveness concerns”.**

Two necessary premises

- i. What is a “**market balance**”, as opposed to market “imbalances”?
 - ii. What can be considered as a “**reasonable amount of time**”? How fast, what is the % ?
- Both Goal 1 and Goal 2 refer to historical and new potential sources of “imbalance”, to be dealt with by the MSR “within a reasonable amount of time”.
 - Before continuing the discussion on the MSR review, these two elements need to be clearly defined.

Market balance

- In the context of the role of the MSR in the EU ETS framework, **we believe that the EU ETS “market balance” could be defined according to two elements:**
 - a) current scarcity on the market, to be identified according to the TNAC being within thresholds, as defined by the MSR Decision;**
 - b) future expectation of market scarcity in the EU ETS, which is driven by both market and political expectations.**

TNAC composition

- Emphasis should also be put on examining the **different components of the TNAC**, seeking to understand how these different components are influenced by, and have an influence on the current and future expected scarcity.
- **Market participants make use of the existing surplus in different ways:**
 - *hedging needs three years ahead, free allowance banked for future use and no longer available for the market, allowances used for compliance today, etc.*
- **Looking at the TNAC as a single entity would not show what volumes are actually available to market players:** the review should capture these nuances as part of the assessment of the MSR performance.
- In the future, the review should also analyse whether **aviation allowances** should be included in the TNAC formula, in order to avoid potential misinterpretations of the EU ETS “market balance”.

Reasonable amount of time

- The MSR Decision does not make an explicit reference to the expected pace of reduction of the surplus.
- However, just achieving a reduction of the surplus would not be sufficient for the MSR to fulfil a positive role – **the MSR is put in place to *improve* the EU ETS ability to deal with market imbalances, compared to a scenario with no-MSR in place.**
- The focus of the review should be on what period of time would be “reasonable”, or “fast enough” for the MSR to play a positive role.
- If the EU ETS is to promote cost-effective decarbonisation, we assume **3 to 5 years** as being a “**reasonable**” timeframe for the MSR to absorb imbalances on the market, given that 3-5 years is the average time for businesses to take investment decisions (IEA, 2019).

Structuring the 2021 review

Proposed structure of the review in 3 parts:

1. The first part should develop a **list of indicators for each of the three goals**, taking into account the elements stated in Article 3.
2. The second part should assess the effectiveness of the MSR in meeting the three goals, to be analysed through the evaluation of the **indicators' performances**. This assessment will serve as the basis to evaluate the continued appropriateness of the existing MSR parameters (intake rate, thresholds, cancellation mechanism).
3. The third part should examine the **possibility for the MSR to assume new goals in the future**, if any.

Track-record and forward-looking analysis of the MSR performance

- If the review were to focus only on the track-record of the MSR, this would result in a fairly limited exercise, both in terms of scope and information available:
 - *as the MSR starts its operations in 2019, any assessment based on its track-record would translate in analysing data and indicators for just two years of operations (e.g.: in 2021, only the 2019 and 2020 TNAC will be available).*
- The review should therefore look at both the track-record of the MSR until 2021, as well as at its expected performance in the period to 2030.
- **This forward-looking analysis could be included in the review through indicators based on modelling exercises and stress tests**, assessing the expected impact of some conceivable “new events” that might affect the market towards 2030 (e.g. announced policies at the EU and MS level, economics shocks, etc.).

Indicators to monitor towards the review

Goal 1 – Eliminate the historical structural imbalance	Goal 2 – Bring the TNAC within range of the MSR thresholds in case of new events	Goal 3 – Monitor the impact of the MSR on competitiveness
<p><u>Indicators for Goal 1:</u></p> <ul style="list-style-type: none"> a. TNAC for 2019-2020 b. Estimated TNAC for Phase 3 compared to TNAC for 2019-2020 c. Estimated number of allowances invalidated in 2023 compared with the difference between the 2018 TNAC and the MSR upper threshold 	<p><u>Indicators for Goal 2:</u></p> <ul style="list-style-type: none"> a.1. Yrs. to absorb variation caused by RES/EE achievements of MS in 2020 vs. 2020 targets a.2. Yrs. to absorb variation caused by RES/EE targets towards 2030 b.1. Yrs. to absorb variation caused by overlapping MS policies (e.g. coal phase outs) in the period 2019-2020 b.2. Yrs. to absorb variation caused by overlapping MS policies (e.g. coal phase outs) for the period to 2030 c.1. Yrs. to absorb variation caused by changes in economic growth in the period 2019-2020 c.2. Yrs. to absorb variation caused by changes in economic growth towards 2030 d. Cumulative impact of all the previous indicators for Goal 2, to be estimated through a comparison of different modelling scenarios indicating the long-term trend of the TNAC towards 2030 e. Alignment of hedging strategies to MSR thresholds 	<p><u>Indicators for Goal 3:</u></p> <ul style="list-style-type: none"> a. Carbon leakage impact of EUA price (both direct and indirect costs) b. Carbon leakage impacts from de-facto reducing the EU ETS cap by invalidating allowances c. Change in auction revenues for MS caused by the MSR d. Implications of the MSR on the innovation and modernisation funds

Looking forward: the MSR review as part of a broader reform to the EU ETS framework?

- **As the EU ETS framework will likely be significantly modified as part of the European Green Deal, the MSR review should be structured as part of a broad and comprehensive reform to the EU carbon market.**
- **Furthermore, this would ensure that any change to the MSR is weighed against possible alternative options, approaching a potential reform to the EU ETS framework in a coherent and concerted way: the MSR should not be seen as a *silver bullet* to all sorts of ills.**