



EUROPEAN COMMISSION

MEMO

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Questions and answers on the proposed market stability reserve for the EU emissions trading system

1. What has the Commission proposed today concerning the EU ETS?

The Commission has presented a legislative proposal to establish a market stability reserve for the EU Emissions Trading Scheme (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.

2. Were stakeholders consulted? How does this link to the Report on the state of the European carbon market in 2012 and the options presented there?

Following the *Report on the state of the European carbon market in 2012*, extensive stakeholder consultation took place in 2013.

The report set out a range of possible measures that could be taken to tackle the large and growing imbalance between the supply and demand for allowances in the EU ETS. The establishment of a market stability reserve emerged as an additional option during a stakeholder meeting in March 2013. A broad spectrum of stakeholders showed openness to this approach. This led the Commission to host an expert meeting in October 2013 to discuss technical aspects related to the possible creation of a reserve.

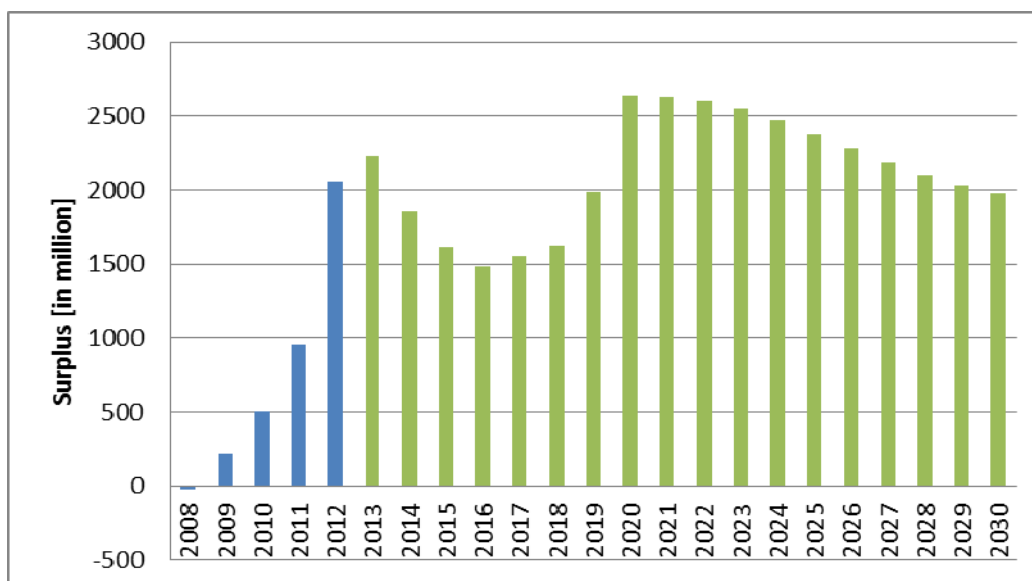
Links to relevant documents and contributions from stakeholders on the consultation and expert meeting can be found at:

http://ec.europa.eu/clima/policies/ets/reform/index_en.htm

3. Why does the EU ETS need a market stability reserve?

The EU ETS was established to deliver EU emissions reduction goals in a harmonised and cost-effective manner. The fact that companies have the choice to purchase allowances if needed to cover their emissions, or sell left-over allowances if they have performed well at reducing emissions, allows the system to find the most cost-effective ways of reducing emissions in the short, medium and long term.

However, in the aftermath of the severe economic crisis the system is characterised by a structural imbalance between the supply and demand of allowances, resulting in a surplus of around 2 billion allowances not needed for compliance. This imbalance has developed mainly in 2011 and 2012, and is expected to persist for at least a decade, if not longer.



Note: The blue columns are based on actual figures, whereas the green ones on estimated figures.

In the existing rules underpinning the EU ETS, the supply of (auctioned) emission allowances is fixed up-front for many years and no changes are allowed to react to major changes in the demand for allowances. This implies a continued imbalance which would undermine and/or postpone innovation and investment in new low-carbon technologies that are required to achieve the objective of making a gradual transition to a low-carbon economy over the long term.

The proposed reserve will complement the existing rules so as to guarantee a more balanced market, with a carbon price more strongly driven by mid- and long-term emission reductions and with stable expectations encouraging low-carbon investments. The system is intended to function to the benefit of companies that have made and will make low-carbon investments.

4. Does this mean a change of the linear reduction factor is not needed?

The creation of a market stability reserve does not affect the level of the cap and the corresponding annual 1.74% linear factor determining the cap.

A change in the linear reduction factor is considered in the debate on the 2030 climate and energy framework. To achieve the overall greenhouse gas (GHG) emission reduction target of 40% by 2030, the cap and consequently the linear reduction factor will also need to be changed to 2.2% (for more information see [MEMO/14/40](#) on 2030 framework). However, we know that the revised annual reduction factor alone will reduce the significant market imbalance in a very gradual manner. In view of this, the market stability reserve is needed alongside and independent of a more ambitious linear reduction factor. A change in the linear factor would most likely lead to a slower build-up of the reserve in phase 4 as a result of applying the proposed rule-set.

5. How does this proposal relate to back-loading?

Back-loading provides a first step to address the supply-demand imbalance over the coming years, but is only a temporary measure. However, the market imbalance is expected to worsen again once the effects of back-loading end, so that the market would still have to operate with the current level of surplus a decade from now. An additional,

structural measure is therefore needed both to address the existing market imbalance and to enable the market to cope better with possible future large-scale demand shocks.

6. What other options were considered in the impact assessment on the structural measures?

The impact assessment on the structural measures considered three main options:

- Permanent retirement of a number of allowances in phase 3 (2013-2020);
- A market stability reserve;
- A combination of these two measures.

The impact assessment has shown that the establishment of a market stability reserve could help address the current imbalance and would make the EU ETS more resilient to any potential future large-scale event that severely disturbs the supply-demand balance.

7. What rules apply for placing allowances in the market stability reserve?

Whether allowances are placed in the market stability reserve is determined according to the "total number of allowances in circulation", a liquidity indicator of allowances in the market not needed for compliance needs.

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

Total number of allowances in circulation in year x = total number of allowances issued from 2008 to year x + total number of international credits used from 2008 to year x – total emissions from 2008 to year x – number of allowances in the market stability reserve in year x .

To ensure transparency, the total number of allowances in circulation in the previous year will be published in May of each year.

From 2021, based on the data published the year before, 12% of the total number of allowances in circulation may be placed in the reserve if and only if this amount is equal to or greater than 100 million allowances.

Example:

In May 2020, the Commission will publish the total number of allowances in circulation in 2019. Assuming that in 2019 the total amount of allowances in circulation was 1.3 billion allowances, 12% of this amount, i.e. 156 million allowances, will be placed in the reserve in 2021, by reducing the 2021 auction volume by the corresponding amount (156 million).

8. What rules apply for releasing allowances from the market stability reserve?

There are two ways in which allowances may be released from the reserve, supposing of course that allowances have previously been placed in the reserve:

1. When the total number of allowances in circulation in a given year is below 400 million, a pre-defined volume of allowances of 100 million allowances is automatically released from the reserve.

2. If for more than six consecutive months the carbon price is more than three times the average carbon price during the two preceding years - even when the total number of allowances in circulation is more than 400 million - the allowances will also be released from the reserve. This safeguard would be in addition to measures taken under Article 29a of the ETS Directive,¹ which allows for moderately increasing the auction supply with allowances from the new entrant reserve in the event of a marked price increase over a 6-month period.

9. Why does the Commission propose 12% and 100 million as the figures concerning the placement of allowances in the reserve, and 400 million concerning their release?

The figures are within the reasonable ranges of what stakeholders have suggested would be the surplus range allowing for the orderly functioning of the market. The combination of the 12% and the 100 million figures defines the maximum surplus in the EU ETS that does not result in placing allowances in the reserve. With these figures, the maximum is set at 833 million allowances (833 million * 12 % = 100 million). The 400 million defines the minimum surplus in the EU ETS that does not result in releasing allowances from the reserve.

10. Who decides when allowances are placed in the reserve and released from the market stability reserve?

The flow of allowances into and out of the reserve will occur on the basis of an automatic, fully rule-based process. When the thresholds and conditions outlined above (see questions 4 and 5) are met, the pre-determined amount of allowances will be placed in or released from the reserve through an operation in the Union registry. The final thresholds, conditions and amounts will be decided up front by EU decision makers when this proposal is agreed by the Council and the European Parliament. No further decisions would be needed and no margin of discretion would be left. Existing institutions established for implementing auctions suffice to implement the proposed rules.

In this regard, this proposal responds to the preference expressed by an overwhelming majority of stakeholders for a non-discretionary mechanism to strengthen the EU ETS and make it more resilient to unexpected shocks.

11. What will happen to allowances at the end of a trading period?

The operation of the market stability reserve is not limited to the fourth trading period but will work across multi-year trading periods. The proposal guarantees that allowances will not be cancelled at the end of a multi-year trading period and that allowances in the reserve will be carried forward to each subsequent trading period. This ensures that allowances remaining in the reserve continue to be available for release in later periods.

12. What will this mean for the operators under the EU ETS? Will the reserve affect the level of free allocation?

Allowances placed in the reserve will be deducted from the allowances due to be auctioned by Member States using the same distribution key as for the auctions themselves. Similarly, when allowances are released from the reserve, they will be auctioned by

¹ Directive 2003/87/EC, amended by Directive 2009/29/EC

Member States in accordance with the current rules, adding to the number that they are allowed to auction in a given year.

The creation of the market stability reserve therefore does not decrease or increase the number of free allowances given to industrial companies under the EU ETS.

Likewise, it does not affect the total quantity of allowances across the European Union ('the cap').

Allowances for aviation activities are not covered by the proposal.

13. What is proposed regarding the transition between trading periods and why is there a need address end-of-period effects?

The proposal aims to make the carbon market more stable and resilient through a better balance between supply and demand. The experience from the recent transition from phase 2 to phase 3 has demonstrated that such transitions tend to be characterised by a marked increase in the auction supply of allowances in the last year of a trading period. This is also expected to occur towards the end of phase 3: additional supply will come to the market, when, for instance, allowances remaining in the new entrants' reserve and other unused allowances (e.g. due to closures of installations) have to be auctioned.

To mitigate the effects of undue end-of-period auction supply peaks, the Commission is proposing an amendment to Article 10 of the ETS Directive. This rule foresees that the additional auction supply would be spread over the final year of a trading period and the first two years of the following period. This provision would only apply for end-of-period peaks, exceeding a threshold.

14. How does the proposal ensure predictability and allow for early learning?

The establishment of the reserve would represent a potentially considerable change to the design and operation of the EU ETS. To maintain maximum predictability, the placing of allowances in the reserve and their release from it will both be done in a gradual manner.

At the same time, it is important to learn from early experience in operating the reserve; this may allow for improvements in its design over time. As a result, it is proposed that a focused review take place by end 2026.

15. Does the market stability reserve mean that the EU ETS loses its market-based nature?

No. The market stability reserve complements the existing rules governing the EU ETS. It is designed as a mechanism based on clear and objective rules, which the market participants can easily understand and whose application can be anticipated. It does not provide for any discretion to change auction supply outside these rules.

The carbon market is a politically created market and needs carefully calibrated rules. Weakened demand usually goes together with decreasing supply. The reserve guarantees that this will also be the case for the carbon market and allows for continued price discovery by the interplay of supply and demand.

16. What are the next steps?

The Commission has submitted this legislative proposal to the Council, the European Parliament, the Committee of the Regions and the Economic and Social Committee for further consideration under the standard legislative procedure.

At the same time, the Council and the European Parliament are invited to consider the 2030 climate and energy framework and endorse the main elements such as the GHG target, the renewable energy target as well as the new governance framework.

See also [IP/14/54](#)