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The European Union Emission Trading Scheme (EU ETS) has been implemented to provide a common climate policy instrument across European Union countries, to contribute to a credible investment perspective for low-carbon investors and support further European integration of energy markets. Thus the EU ETS is a key element of the European Energy Union.

However, given the accumulation of a large surplus in the EU ETS, there is now a consensus between the European Commission, the European Council and the European Union Parliament (ENVI vote) that a Market Stability Reserve (MSR) needs to be implemented. The Latvian Presidency announced on March 26th a mandate to start trilogue negotiations on the implementation of an MSR. Yet there remains discrepancy on the design parameters which will determine how quickly the MSR can respond to the surplus and restore consistency, price credibility, and robustness for investors of EU ETS.

If Europe misses the opportunity to secure a timely restoration of EU ETS, then individual member states are likely to implement national measures to deliver energy and climate objectives. For example Germany has started to debate a Carbon Price add on for very carbon intensive power production to secure modernization and efficient power production should the EU ETS price not recover by the end of the decade.

In this Roundup, we explore five design elements of the MSR that will determine the speed at which the most prominent European energy and climate policy instrument, the EU ETS, can deliver consistency, price credibility, and robustness for investors. The discussion of these design elements in the trilogue process that begins today will show how serious EU member states are not only about Climate Policy but equally about the Energy Union as a common policy framework to enhance investment and energy security across Europe.

The Market Stability Reserve debate

In January 2014 the European Commission proposed the introduction of a Market Stability Reserve (MSR) to improve the functioning of the European Union Emissions Trading System (EU ETS). According to the European Commission, the MSR is designed to adjust the EU ETS to supply-demand imbalances and protect the system from unexpected and sudden demand shocks ([European Commission, 2014a](#))

and by doing so, ensure an efficient abatement pathway for the long-term decarbonisation of the European economy ([Climate Strategies 2015](#)).

In October 2014 the European Council expressed support for a policy intervention “in line with” the Commission’s proposal. After some debate, in February 2015 the ENVI Committee also voted in favour of an MSR similar to that proposed by the Commission, albeit with some amendments ([ENVI, 2015](#)). Alternative design options have been put forward by Member States including Germany, the United Kingdom, France and Latvia (in its role as the EU Presidency).

The trilogue process starting on 26.3.2015 will have to find an agreement on five design elements of the Market Stability Reserve. These will be discussed in the points below.

Back-loaded allowances

Under the European Commission’s proposal, 900 million allowances that are to be removed from the market between 2014 and 2016 will be returned to the market in 2019 and 2020 preceding the introduction of the MSR ([European Commission 2014b](#)). The German and United Kingdom governments have argued that return of the back-loaded allowances to the market is at odds with the goals of the MSR as it would prolong the demand-supply imbalance (BMUB 2014). A direct transfer of the back-loaded allowances has been a key component of both the recent ENVI ([2015](#)) and Latvian MSR proposals.

Timing of Implementation

The timing of implementation has emerged as a critical element of the MSR debate. The original proposal from the European Commission was for implementation in 2021. However, a strong contingent of member states favour a 2017 start. A 2017 start has also been favoured by an alliance of more than [60 utilities](#) and associations in the energy sector that believe reform should be brought to life as soon as possible. However, Eastern European member states oppose an early start to the MSR mainly due to concerns that this could lower revenues from the sale of carbon allowances or create risks of carbon leakage should carbon leakage protection measures not be continued post 2020 ([Point Carbon 2015](#)). The ENVI Committee voted for a starting date of 2018 and other dates like 2019 were proposed in early March by Latvia.

Treatment of unused Allocation

Allowances that remain in the New Entrants Reserve in 2020 as well as allowances that were allocated based on historic benchmarks to installations but are no longer required given plant closure or reduced activity levels according to existing legislation are to be auctioned in the final year of the trading period (European Union 2009). The number of these unused allowances is anticipated to be in the range of 500-900 million ([Ecofys 2015](#); [Sandbag 2015](#); [ISCS Tschach 2015](#)). As such, it is argued that a sudden change of annual auction volumes will induce volatility and increase the allowance surplus, which is contrary to the goal of the MSR to adjust the EU ETS to *supply-demand imbalances and protect the system from unexpected and sudden demand shocks* (IETA, 2015). Hence the ENVI Committee proposal envisages a direct transfer of unused allowances to the MSR.

Speed of response

The MSR as proposed by the European Commission is triggered with a two year delay. A delay between when a change in the surplus takes place and when an intervention takes place may reduce the effectiveness of the instrument and increase price volatility (Taschini et al., 2014; Trotignon et al., 2014). The ENVI Committee has proposed to shorten the time lag to one year. This has been met with two concerns. First, it has been questioned whether it provides market participants enough time to respond to announcements of new schedules. But Taschini et al. (2014) argue that market participants will anticipate the automated adjustment. Second, as verified emissions data are only published in May of the following year, the auctioning schedule would need to be changed within the year. Point Carbon (2014) suggests the use of verified emissions data in May to adjust the auction quantities from June to July of the following year.

Review process

The review process has perhaps received less attention than the other design features but remains to be an important component of MSR design. In the original European Commission proposal, the MSR was to be reviewed within six years of operation ([European Commission, 2014a](#)). However, the ENVI Committee has proposed review after only three years. It argues that given uncertainty over parameters such as the MSR trigger levels a well-timed review is essential. Also an international model comparison exercise emphasises the need for early review to ensure thresholds align with hedging demand ([Climate Strategies 2015](#)), because too high thresholds could make the MSR ineffective while too low thresholds could create undue price instability. As the hedging needs of the power sector will evolve with the total power demand, the carbon intensity of the power production and the volume of forward contracting, the authors argue for a quicker review process which updates of the trigger levels based on empirical data on hedging demand that is collected under the European Union Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) Directive.

How do the MSR designs compare?

So how do the different MSRs compare? The stated aim of the MSR was to adjust the EU ETS to supply-demand imbalances and protect the system from unexpected and sudden demand shocks. All the MSR designs under discussion retain the thresholds and withdrawal as well as injection quantities proposed by the European Commission. Once the surplus beyond hedging needs is transferred to the MSR, all proposals can be expected to deliver similar improvements on key criteria, in particular moving Europe towards an efficient abatement pathway and enhancing the robustness of the EU ETS to unexpected shocks.

The proposals differ in the speed at which the historic surplus is transferred to the MSR and the volatility of annual auction volumes during this period. All amendments to the initial European Commission's proposal avoid the return of back-loaded allowances to the market. This increases price credibility and provides a stronger signal for investment in decarbonisation, particularly over the next decade (according to [Climate Strategies 2015](#)).

The key difference between the different proposals is the implementation date. Every year that the implementation is delayed beyond 2017 will delay the transfer of surplus allowances into the MSR. Dependent on the treatment of unallocated allowances this will constitute about 200 million allowances per year.

An important feature of the proposal by the ENVI Committee is the direct transfer of unused allowances from new entrant reserve and unused free allocation due to plant closure to the MSR. This will avoid volatility due to a jump in auction volumes in 2020 and accelerates the process of return to supply-demand equilibrium.

Conclusion

The design of the MSR needs to balance two objectives. First and foremost it needs to contribute to a stable operation of the EU ETS for a sustainable investment framework. Secondly, it has to avoid undue delays in return to such a stable operation.

To achieve the first objective, all currently discussed proposals of the MSR envisage modest speeds of transfer of surplus allowances into the MSR, so as to avoid excessive response to shocks. However, this inherently limits the speed at which the historically accrued surplus can be transferred into the MSR.

Hence, to better achieve the second objective, the different MSR proposals currently discussed, consider different starting dates for the MSR and a direct transfer of back-loaded allowances and unused allowances in the new entrant reserve into the MSR. This offers the benefit of reducing undue volatility of auction volumes and can accelerate the return of EU ETS to stable operation with consistent and credible prices for low carbon investments in Europe.

The outcome of the trilogue process on these design elements may influence whether member states will have to resort to national policies to support the carbon price and investment framework, or whether they can strengthen their cooperation based on a functioning EU ETS as central pillar of the European Energy Union.

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