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Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC

(Text with EEA relevance)

{SWD(2014) 17}
{SWD(2014) 18}

EXPLANATORY MEMORANDUM

1. INTRODUCTION

At the start of the third trading period (2013-2020), the EU Emissions Trading System (ETS) was characterised by a large imbalance between supply and demand of allowances, resulting in a surplus of around 2 billion allowances that is expected to grow over the coming years to more than 2.6 billion allowances by 2020. The reason for this imbalance is primarily a mismatch between the auction supply of emission allowances, which is fixed in a very rigid manner, and demand for them, which is flexible and impacted by economic cycles, fossil fuel prices as well as other drivers. Weakened demand usually goes together with decreasing supply. However, in the EU carbon market this is not the case for auction supply in the current regulatory regime.

The EU ETS was set up to deliver EU emissions reduction goals in a harmonised and cost-effective manner. While the environmental objective is guaranteed by the cap, the presence of a large surplus reduces the incentives for low-carbon investment and thereby negatively affects the cost-efficiency of the system. Where economic actors take investment decisions against the background of an oversupply of allowances in the market and the corresponding price signal, overall costs relevant for the climate change challenge are bound to increase when considered over the mid- and long-term. In short, if not addressed, these imbalances will profoundly affect the ability of the EU ETS to meet the ETS target in future phases in a cost-effective manner, when significantly more demanding domestic emission objectives than today would have to be reached[1].

It is expected that the 2030 greenhouse gas target decided as part of the climate and energy policy framework will result in a more ambitious linear reduction factor applied as of the start of phase 4 in 2021. This would relieve the market imbalance over time and in a gradual manner. However, the impact assessment accompanying the 2030 framework illustrates that a more ambitious linear factor is insufficient to address the negative implications of the severe market imbalance. At the same time it would also leave the EU ETS unprotected against future unexpected and sudden demand shocks.

For these reasons, the provisions of the Directive should be derogated from to establish a market stability reserve.

2. CONTEXT OF THE PROPOSAL

As a short term measure to mitigate the effects of the surplus it was decided to postpone ("back-load") the auctioning of 900 million allowances in the early years of phase 3. In this context the Commission also reaffirmed its commitment to present options for action with a view to adopting further appropriate structural measures to strengthen the ETS during phase 3[2].

Considering that the surplus is of a structural, long-lasting nature further action to strengthen the EU ETS is necessary to ensure a cost-efficient transition to a low-carbon economy. The Commission set out a non-exhaustive list of six options for structural reform of the EU ETS in

[1] COM(2012) 652 final
[2] COM(2012) 416 final

its Report on the State of the European Carbon Market in 2012 (Carbon Market Report)[3] in November 2012. During the public consultation that followed this report, the establishment of a market stability reserve that could render the auction supply of emission allowances more flexible and increase shock resilience emerged from the discussion as an additional option.

An impact assessment report and an executive summary are published together with the present proposal. The impact assessment has shown that the establishment of a market stability reserve could help address the current imbalances and also would make the ETS more resilient to any potential future large-scale event that may severely disturb the supply-demand balance. With regard to the different design elements, it has shown that operating the market stability reserve in relation to the total number of allowances in circulation has the advantage to capture changes in demand not only due to macroeconomic changes, but also impacts of other factors such as complementary policies, as well as changes on the supply side like the inflow of international credits.

3. LEGAL ASPECTS OF THE PROPOSAL

To ensure predictability, the market stability reserve is designed as an objective and rule-based mechanism on the basis of which the auction volumes are adjusted in an "automatic manner" under pre-defined conditions applied as of phase 4 of the EU ETS starting in 2021. While the impact assessment has shown that establishing a market stability reserve already in phase 3 would deliver benefits for the strengthening and the efficiency of the carbon market, back-loading is expected to provide some temporary relief in the coming years. It is therefore proposed to establish the market stability reserve at the start of phase 4 so as to provide market participants with lead-time to adapt to the introduction of the reserve and sufficient regulatory certainty during phase 3 of the EU ETS.

The market stability reserve set out in this proposal functions by triggering adjustments to annual auction volumes in situations where the total number of allowances in circulation is outside a certain predefined range:

(a) Adding allowances to the reserve by deducting them from future auction volumes with the aim of mitigating market instability due to a large temporary surplus in the EU ETS if the total surplus is higher than 833 million allowances;

(b) Releasing allowances from the reserve and adding them to future auction volumes with the aim of mitigating market instability due to a large temporary deficit in the EU ETS provided the total surplus is below 400 million allowances..

Allowances are thus placed in and released from the market stability reserve in relation to the total number of allowances in circulation. This indicator is a direct measure for the actual imbalance between supply and demand and is thus preferred over more indirect and uncertain measures for important market drivers such as GDP, fuel prices, weather and precipitation, etc. The upper and lower boundaries of the range were determined following consultations with stakeholders and reflect a range where experience shows that the market was able to operate in an orderly manner.

To ensure predictability and more gradual changes to the market stability reserve, a pre-defined volume of 100 million allowances per year would be released from the reserve where

[3] COM(2012) 652

the conditions are met. This quantity represents roughly 5% of the current annual emissions in the EU ETS which based on historical experience should be sufficient to cater for even very sudden and strong increases in demand.

The introduction of a market stability reserve represents potentially a significant change to the design and operation of the EU ETS. Early lessons from operating the reserve rules may prove valuable and allow for improvements in the design of the reserve rules. At the same time predictability and stability are important for a successful carbon market. In order to strike the right balance the proposal foresees a review with particular focus on certain reserve parameters by 2026.

The proposal also contains provisions aimed at smoothening auctioning supply in the years around transitions between trading phases in cases where the default would otherwise have resulted in sharp changes. This effect is volume neutral over the three-year period and consists of a simple averaging of annual volumes that mitigates potential transitional and temporary impacts on the auction supply from the modalities set by Directive 2003/87/EC and Commission Regulation No 1031/2010 for the end of the period with regard to e.g. allowances remaining in the new entrants' reserve at the end of the period, allowances not allocated due to closures or under the derogation for the modernisation of the electricity sector. If the volume of allowances that should be auctioned in the last year of the period exceeds the average amount to be auctioned in the two following years by more than 30%, this difference will be evenly distributed over these years. This provision builds on the experience gained in the transition from phase 2 to phase 3 of the EU ETS and avoids a repeat of the negative implications of transitional modalities.

The proposal takes the same legal basis as Directive 2003/87/EC. Given its background and temporal scope, it is submitted as a part of the 2030 framework for climate and energy policies.

The EU's right to act stems from the fact that the ETS operates as a Union-wide system in a fully harmonised manner. It is in conformity with the subsidiarity and proportionality principle set out in Article 5 of the Treaty on the European Union.

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THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 192(1) thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national Parliaments,

Having regard to the opinion of the European Economic and Social Committee[4],

Having regard to the opinion of the Committee of the Regions[5],

Acting in accordance with the ordinary legislative procedure,

Whereas:

(1) Article 10(5) of Directive 2003/87/EC of the European Parliament and of the Council[6] provides that an annual report on the functioning of the European carbon market should be submitted each year to the European Parliament and the Council.

(2) The report from the Commission to the European Parliament and the Council on the state of the European carbon market in 2102[7] identified the need for measures in order to tackle structural supply-demand imbalances. The impact assessment on the 2030 climate and energy policy framework[8] indicates that this imbalance is expected to continue, and would not be sufficiently addressed by adapting the linear trajectory to a more stringent target within this framework. A change in the linear factor only changes gradually the cap. Accordingly, the surplus would also only gradually decline, such that the market would have to continue to operate for more than a decade with a surplus of around 2 billion allowances or more. In order to address this problem and to make the European Emission Trading System more resilient to imbalances, a market stability reserve should be established. To ensure regulatory certainty as regards auction supply in phase 3 and allow for some lead-time adjusting to the introduction of the design change, the market stability reserve should be established as of phase 4 starting in 2021. In order to preserve a maximum degree of predictability, clear rules should be set for placing allowances into the reserve and releasing them from the reserve. Where the conditions are met, beginning in 2021, allowances corresponding to 12% of the number of allowances in circulation in year x-2 should be put into the reserve. A corresponding number of allowances should be released from the reserve when the total number of allowances in circulation is lower than 400 million.

(3) Furthermore, in addition to the establishment of the market stability reserve, a few consequential amendments should be made to Directive 2003/87/EC to ensure consistency and smooth operation of the ETS. In particular, the operation of Directive 2003/87/EC may lead to large volumes of allowances to be auctioned at the end of each trading period which can undermine market stability. Accordingly, in order to avoid an imbalanced market situation of supply of allowances at the end of one trading period and the beginning of the next with possibly disruptive effects for the market, provision should be made for the auctioning of part of any large increase of supply at the end of one trading period in the first two years of the next period.

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4 OJ C , , p. .

5 OJ C , , p. .

6 Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (OJ L 275, 25.10.2003, p. 32).

7 COM(2012)652 final.

8 Insert reference.

(4) The Commission should review the functioning of the market stability reserve in relation to its operation in the light of experience of its application. The review of the functioning of the market stability reserve should in particular consider whether the rules on placing allowances in the reserve are appropriate with regard to the aim pursued to tackle structural supply-demand imbalances.

(5) Articles 10 and 13(2) of Directive 2003/87/EC should therefore be amended accordingly,

HAVE ADOPTED THIS DECISION:

Article 1
Market stability reserve

1. A market stability reserve is established, and shall operate from 1 January 2021.

2. The Commission shall publish the total number of allowances in circulation each year, by 15 May of the subsequent year. The total number of allowances in circulation for year x shall be the cumulative number of allowances issued in the period since 1 January 2008, including the number issued pursuant to Article 13(2) of Directive 2003/87/EC in that period and entitlements to use international credits exercised by installations under the EU emission trading system in respect of emissions up to 31 December of year x, minus the cumulative tonnes of verified emissions from installations under the EU emission trading system between 1 January 2008 and 31 December of year x, any allowances cancelled in accordance with Article 12(4) of Directive 2003/87/EC and the number of allowances in the reserve. No account shall be taken of emissions during the three-year period starting in 2005 and ending in 2007 and allowances issued in respect of those emissions. The first publication shall take place by 15 May 2017.

3. In each year beginning in 2021, a number of allowances equal to 12% of the total number of allowances in circulation in year x-2, as published in May year x-1, shall be placed in the reserve, unless this number of allowances to be placed in the reserve would be less than 100 million.

4. In any year, if the total number of allowances in circulation is lower than 400 million, 100 million allowances shall be released from the reserve. In case less than 100 million allowances are in the reserve, all allowances in the reserve shall be released under this paragraph.

5. In any year, if paragraph 4 is not applicable and measures are adopted under Article 29a of the Directive, 100 million allowances shall be released from the reserve. In case less than 100 million allowances are in the reserve, all allowances in the reserve shall be released under this paragraph.

6. Where action is taken pursuant to paragraphs 3 or 5, the auction calendars shall take into account the allowances placed in the reserve or to be released from the reserve.

Article 2
Amendments to Directive 2003/87/EC

Directive 2003/87/EC is amended as follows:

1. Article 10(1) is replaced by the following:

2. "1. From 2021 onwards, Member States shall auction all allowances that are not allocated free of charge in accordance with Article 10a and 10c and are not placed in the market stability reserve established by Decision [*OPEU please insert number of this Decision when known*] of the European Parliament and of the Council(*)."

3. In Article 10, the following paragraph shall be inserted:

"1a. Where the volume of allowances to be auctioned by Member States in the last year of each period referred to in Article 13(1) exceeds by more than 30% the expected average auction volume for the first two years of the following period before application of Article 1(3) of Decision [*OPEU please insert number of this Decision when known*], two-thirds of the difference between the volumes shall be deducted from auction volumes in the last year of the period and added in equal instalments to the volumes to be auctioned by Member States in the first two years of the following period."

4. In the second subparagraph of Article 13(2) the following sentence is added:

"Similarly, allowances held in the market stability reserve established by Decision [*OPEU please insert number of this Decision when known*] and which are no longer valid shall be replaced by allowances which are valid for the current period."

Article 3
Review

By 31 December 2026, the Commission shall on the basis of an analysis of the orderly functioning of the European carbon market review the market stability reserve and submit a proposal, where appropriate, to the European Parliament and to the Council. The review shall pay particular attention to the percentage figure for the determination of the number of allowances to be placed into the reserve according to Article 1(3) and the numerical value of the threshold for the total number of allowances in circulation set by Article 1(6).

Article 4
Transitional provision

Article 10(1) of Directive 2003/87/EC as amended by Directive 2009/29/EC shall continue to apply until 31 December 2020.

Article 5
Entry into force

This Decision shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Done at Brussels,

For the European Parliament
The President

For the Council
The President