The threat of wasted capital – why ETS reform needs to come into effect in 2017
This paper argues that the reform of the ETS needs to come into effect in 2017 rather than 2021 in order to avoid a lost decade for climate protection and in order to encourage innovation. The allowances due to re-enter the market in 2019 and 2020 from backloading should be placed in the market stability reserve instead of flooding the market. The paper argues that the market stability reserve will not increase volatility to a larger extent than a central bank approach. It further argues that due to past experience, investors will – unless the ETS reform is brought forward – only start making investment decisions based on the ETS in the mid- to late-2020s.

The state of play

Let us start by looking at the current situation of the Emissions Trading Scheme (EU-ETS). The ETS is currently not a major factor driving investment decisions across the European Union. The promotion of renewable energy, slight improvements in energy efficiency, and the economic slowdown as a result of the financial crisis have been the major factors driving decarbonisation in Europe in the past few years. The ETS has been rendered nearly irrelevant due to its fixed cap, the significant surplus of allowances in the system, and the resulting inability to deal with large demand shocks. This needs to change, because the ETS has the potential to become the primary driver of decarbonisation in the European Union and therefore – through its design – ensure the most cost-effective route to decarbonisation. Re-establishing the EU-ETS as a successful instrument of climate policy will also drive the introduction of carbon markets across the world.

The temporary withholding of auctioning volumes from the ETS (“backloading”) is not an unwelcome intervention. It seems that the Commission, once the grand reform of the EU-ETS through an increase in the mitigation target for 2020 to 30% failed, saw this as a confidence-building measure. But the way that backloading made its way through the European institutions slowly and with many surprising turns has not necessarily restored investor confidence in the EU-ETS. As a result, the EU-ETS is seen as a mere upside in investment decisions rather than the main pillar of EU climate policy that it was intended to be. However, the likely adoption of backloading has created a political space for a more fundamental reform of the ETS by building political confidence.

As part of the 2030 package, the European Commission proposed a major reform of the EU-ETS that would not only steepen the factor by which the cap is lowered every year but also introduce a market stability reserve (MSR). The stability reserve would manage the surplus in the EU-ETS by automatically withholding 12% of allowances in circulation every year, and only releasing part of them if the amount of allowances in circulation falls below a certain threshold. This is intended to improve the ability of the emissions trading scheme to deal with variations in demand, without determining price levels. It is essentially a move away from a fixed cap on EU-ETS allowances to a flexible cap.

The market stability reserve versus a central bank for carbon

There are three main factors that should be considered in the design of ETS reform. These are political acceptability and likelihood of adoption, environmental effectiveness, and incentives for long-term innovation. Environmental effectiveness is determined by price levels and price stability as well as the credibility of policy-maker commitment to the ETS, which has an
impact on the discount rates applied by market actors to future carbon prices. There are two main reform proposals currently being discussed, the MSR and an independent central bank for carbon. By allowing market intervention by a government body, they both address the main shortcomings of current EU-ETS design, such as the inability of the system to deal with demand shocks and the inability to address the interaction with other, complementary policies. The main difference is if that intervention should be automatic (MSR) or discretionary (central bank for carbon).

Proponents of the central bank for carbon argue that the MSR will increase, rather than decrease, market volatility and therefore weaken the clarity of the price signal. The main reason for this is banking – market participants will anticipate rising prices by buying up permits while prices are still low, and may therefore trigger the market stability reserve for purely financial reasons rather than due to the underlying market fundamentals, making the market stability reserve a source of instability rather than stability. According to this line of reasoning, “mechanical” triggering of market intervention can only be avoided by an independent committee of experts overseeing the carbon markets much like a central bank.

However, a limited degree of intermediation around the announcement of surplus levels could actually be market-making and thus beneficial. In addition, high discount rates applied by market participants due to political uncertainty will limit banking and thus make the mechanical triggering of the reserve unlikely. Proponents of the central bank for carbon focus on the shortcomings of the MSR without acknowledging important shortcomings of the central bank approach. The automation offered by the MSR will in fact limit, rather than expand, speculation by providing predictability to market participants – while the central bank approach will lead to large speculation around announcements by the central bank for carbon board. In addition, depending on the amount of limitations policy-makers put on the mandate of the central bank for carbon, the central bank for carbon will either make the market unpredictable or quasi-robotic.

The most important argument in favour of the MSR is predictability – surplus levels will be published way in advance of market intervention and will allow market participants to adapt before the intervention occurs, thereby most likely smoothening price development. The MSR will lead to the gradual increase in carbon prices that is necessary in order to provide long-term signals to power market participants such as plant operators, rather than triggering excessive volatility when speculation around central bank board decisions occurs. This is necessary because long-term price signals are essential in a sector driven by investment cycles lasting several decades.

Another important argument in favour of the MSR is political acceptability. Delegation of carbon market management to a central bank for carbon would require – most likely – a change to the treaties of the European Union, making this a highly difficult undertaking. In addition, this would create a powerful new institution that would be highly controversial. In the context of the overall 2030 negotiations, this would make the only major piece of the 2030 package that so far can be adopted by qualified majority a proposal that also requires unanimity, weakening the hand of progressive countries. Potentially, the mandate of the central bank would even need to include price objectives in the same way that some countries have set inflation targets for their central banks – and therefore lead to a politically toxic discussion about taxation that also requires unanimity and that will most likely be rejected even by progressive countries because they reject the idea of EU-wide taxes for reasons of principle. By being focussed on volumes rather than prices and by automating a process that would otherwise put enormous pressure on the central bank board, the MSR reflects the art of the possible.

When should it start to bite?

The European Commission wants the MSR to start operating in 2021. This is not because the Commission wants to delay action, it is because Commission analysts expect market participants to discount allowances issued before 2021 and bank them in order to prepare for the robust ETS.
The idea is that this will smoothen the price curve and compensate for the 900 million allowances that will enter the system in 2019 and 2020 from backloading. In addition, the European Commission does not want to reopen the political consensus around the 2020 targets. I do not believe that price smoothening will happen to the extent anticipated by the Commission. Due to the failure of the 30%-discussion and because of the long and complicated route towards backloading, many market participants have lost confidence in policy-makers adequately managing the ETS. Before major investment decisions in the power sector are made based on the ETS, the price needs to reach a significant level and stay there for a prolonged period of time. The ETS needs to go through a period of success before its credibility is restored.

If this period of success is only started in 2021, the ETS will miss the opportunity to make an impact on most of the power sector investments that will shape the success or failure of the EU to reach the 2030 GHG target. When the price then reaches significant, abatement-grade levels in the mid to late 2020s, most assets will already be built and will become stranded. This is a huge waste of capital. Most investors can be expected to apply high discount rates to future carbon prices not least because of the political and methodological uncertainty surrounding them and their predicted price levels. Even though it makes complete economic sense to start work on the 2030 target immediately, the discount rates applied to the promise of a high carbon price in the mid to late 2020s will make that a nearly irrelevant factor in investment decisions this side of 2020. The further we push a high carbon price into the future, the further we delay transforming our power sector and the more capital we waste on high-carbon assets. Technological leadership in new renewable energy technologies can be defended through a high carbon price this side of 2020. The 2020 targets have demonstrated how successfully the EU can incentivise innovation.

Lastly, the development of the surplus in the ETS has been modelled extensively and will – if the credits from backloading are reintroduced in the late 2010s – lead to a price increase before 2019, a collapse in the price when the 900 million allowances re-enter, and a slow increase after that. Accepting the premise that volatility is bad for the users of allowances, this amounts to tremendous mismanagement for no logical reason. Why risk the progress we are making by reducing the surplus slightly and not ensure a smooth development of prices that provides a reliable and continuous price signal to make that gradual transition towards low emissions that we need? This would enable market participants to adapt. This would enable a gradual increase of the price that will waste as little capital as possible.

To avoid wasting capital in volatility, and to ensure the transformation of the power sector based on the ETS can start as soon as possible, we need to start the MSR earlier than 2021.

**Conclusion**

The paper welcomes the proposal of a market stability reserve that is inspired by political realism and would provide a more predictable and stable price incentive compared to a central bank approach.

A gradual increase in price levels is more economical than excessive volatility, especially when taking into account power sector investment horizons. The market stability reserve should come into effect in 2017 rather than in 2021 (as proposed by the Commission), because low investor confidence in the carbon market needs to be restored as early as possible.
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