Is the EU ‘shooting from the hip’ by raiding the Market Stability Reserve?

Published 2 June 2022

Nitesh Shah
Head of Commodities and Macroeconomic Research, WisdomTree Europe

The price of EU emission Allowances (EUAs) fell more than 9% intraday on Wednesday, 18 May 20223, as the EU’s ill-thought-out proposals to wean off Russian fossil fuels were announced. We have long-argued that the green energy transition and energy independence from Russia should go hand-in-hand, given that Russia is a large exporter of oil, natural gas and coal (i.e. green-house gas emitting hydrocarbons) to the EU. However, we struggle to understand some of the logic in the recent announcement on financing this transition and feel it will be self-defeating.

What was in the announcement?

REPowerEU is the name of the plan the European Commission has proposed to end the EU’s dependence on Russian fossil fuels. While some aspects of their proposal seem logical, and further their existing goals of promoting energy efficiency and a transition to lower green-house gas emitting technologies, we believe their chosen method to finance the operation will ultimately hurt their goals.

The Recovery and Resilience Facility (RRF) is a relic of the post-COVID recovery plan and a green transition is one of the central pillars of that programme. REPowerEU aims to bolster funding to this plan. But, by raiding the Market Stability Reserve of the EU Emissions Trading Scheme, they threaten to do the opposite.

What is the MSR?4

EU Emissions Trading Scheme, launched in 2005, has suffered from chronic over-supply of allowances for most of its history. Between 2014 and 2016, allowance auction volumes were reduced by a cumulative 900 million, with the view to backload them at the end of the period. However, oversupply of the market was deemed so large that these allowances were never auctioned but placed into a Market Stability Reserve (MSR). Every year since then, a certain amount of allowances have been placed into the reserve instead of being auctioned. Releasing allowances from the MSR requires sharp price increases over a short period of time5. EUAs have never been released from the MSR as the threshold is quite high. That had cemented the view of a binding supply constraint that has been successful in restoring credibility in the system.

Raiding the MSR

The European Commission (EC) has proposed raising €20 billion to increase the RRF by selling allowances from the MSR. At close to €85/tonne6, more than 235 million allowances would need to be sold at current prices to raise that amount (more will need to be sold if the price declines further). As of

31 December 2021, there was just over 2.6 billion allowances in the reserve. While there are plenty of allowances in the reserve, the mechanism was never designed as a piggybank to be raided for financial resources. The consequence of taking allowances out of the reserve will be to lower EUA prices. That would be detrimental to achieving the 'right' carbon price to incentivise the green transition. Moreover, the ad hoc policy making of tapping the reserve outside of price-shock events will damage the credibility of the system. The EC claim they will auction allowances in a manner that "does not disrupt the market". We are not sure how selling such a large volume of allowances will not have an impact on price.

Will it be implemented?

Like all proposals from the EC, the EU Parliament will have to approve. We hope that Members of the European Parliament recognise the lack of logic in the proposal. At the same time, Parliament is debating on tightening the MSR as part of the Fit for 55 Legislation. If the contradictions are laid bare, the proposals to raid the MSR could fall flat. However, the risk of policy error is high.

Progress made elsewhere was overshadowed by this news

On Tuesday 17 May, the Committee on Environment, Public Health and Food Safety adopted their report on the regulation establishing a Carbon Border Adjustment Mechanism (CBAM) with 49 votes for, 33 against and 5 abstentions. That is one of the key components of the Fit for 55 Legislation. As we discussed in the EU Emissions Trading System (ETS) Primer, this mechanism is important to reduce carbon leakage and therefore allow the EU to auction allowances to sectors that currently receive their allowances free. The various proposals made by MEPs push for a more ambitious CBAM, with a faster phasing out of free allowances and a centralised CBAM authority (rather than have each member state have slightly different policies). There are several stages of approval before the proposals are implemented. CBAM has always been a controversial plan, met with resistance from exporters to the EU. However, with around 27 % of global CO2 emissions from fuel combustion coming from internationally traded goods7, the EU's resolve in pushing this through could be a game-changer in driving lower global emissions.

1 Source: Bloomberg data using December 2022 EUA futures price on 18/05/2022

2 Source: Bloomberg data using December 2022 EUA futures price on 18/05/2022

3 Source: Bloomberg data using December 2022 EUA futures price on 18/05/2022

4 See EU Emissions Trading System (ETS) Primer for more on the MSR

5 Article 29a of the current ETS rules allows countries to add extra allowances to the market only if the EUA price is, for at least six months, more than three times the average price in the two preceding years, and if policymakers conclude this does not reflect market fundamentals.

6 Source: Bloomberg data using December 2022 EUA futures price on 18/05/2022

7 EU Parliament

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