

New reforms to the EU's emissions trading system are welcome, but the devil will be in the details

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The EU's emissions trading system employs a 'cap and trade' framework under which a 'cap' on the level of greenhouse gas emissions is set, with allowances for emissions becoming tradable between business and other actors. Since the financial crisis, however, a surplus of emission allowances has built up, undermining the effectiveness of the system. [Luca Taschini](#) writes on a recent proposal, approved in the European Parliament on 8 July, to tackle this problem by creating a so called 'Market Stability Reserve'. He argues that while this should be seen as a positive development, its impact will depend heavily on the details of the reform that are eventually agreed between national governments.



This month has seen two major announcements for the European Union Emissions Trading System (EU ETS). The European Parliament approved, on 8 July, the introduction of a Market Stability Reserve (MSR). And, on 15 July, the European Commission [announced](#) its 'summer package' for energy, which included proposed reforms to the number of free emissions allowances companies are eligible for.

As it stands, the supply of allowances in the EU ETS is determined within a rigid allocation programme. A reform of the EU ETS intends to make the allocation of allowances flexible so that it can adapt to changes, such economic shocks and technological advancements. The challenge for policymakers is to design a flexible system that helps regulate a market affected by future uncertainty, whilst also limiting the complexity of that system.

I have previously argued in favour of a reform of the European Union Emissions Trading System (EU ETS) that makes the system more responsive to unexpected price shocks. [A policy paper last year](#) proposed a rules based mechanism for withdrawing and injecting allowances from the market based on price trends.

So the vote in favour of an MSR by the European Parliament should be welcomed. However, it still needs to be approved by EU environment ministers on 18 September and the exact details will no doubt be the subject of great debate. But this is an attempt to fix the root cause of the problems with the system: the rigid allowance allocation programme.

As outlined in [a policy paper](#), I have found that only long-term structural reforms – such as the introduction of an MSR – can incorporate the flexibility required by the EU ETS. This will allow the EU ETS to respond to economic shocks. When the number of unused emissions permits in the system grows too large, the MSR means they can be removed automatically. If there are too few permits in the system, more can be added automatically.

The strength of the proposed MSR is that it is a rules-based market mechanism. The exact design of the mechanism is yet to be decided. Crucially, there are four parameters to be decided on: first, the point at which the system contains 'too many' permits; second, the point at which the system contains 'too few' permits; third, the rate at which new permits are added to the system; and fourth, the rate at which permits are removed from the system.

Setting the levels of 'too many' or 'too few' permits is likely to prove controversial. Green industries and green campaigners will call for fewer permits in the system. And those on the other side of the argument will want more permits in the system. All parties are likely to be left feeling dissatisfied. This could prove a significant political barrier to agreeing an effective MSR mechanism.

Environment ministers in the European Commission would be better placed focussing on just one number: a single

rate at which permits are added to and removed from the system. A single rate would effectively create a quantity corridor with an implied upper limit and an implied lower limit. The higher the rate at which permits are added to or removed from the system, the more controlled the quantity of unused permits in the system will become. A higher rate leads to a narrower quantity corridor.

A more controlled quantity of permits also makes the system more resilient to shocks – it *stabilises* the system. Hence Market *Stability Reserve*. However, a highly controlled quantity of permits increases micromanagement and undermines the fact that the EU ETS is a market-based mechanism. There is therefore a trade-off to be had.

[Our analysis](#) investigates this trade off and proposes a tool for the selection of an optimal adjustment rate.

Based on the modelling assumptions, the resulting rate at which permits are added to and removed from the system does not seem to be far from the adjustment rate indicated by the European Commission.

When all is considered, the European Commission's suggestion of 12 per cent of permits in the system per annum looks to be in the right ballpark. It is also positive that the European Parliament has brought forward the date at which it introduces the MSR to 2019, two years earlier than initially suggested. Our research has previously recommended that the MSR should be introduced as soon as it possibly can.

The Commission must now ensure that debates over the exact design of the MSR do not come at the detriment of an effective emissions trading system. After all, the main goal is to create an incentive that begins to decarbonise the European economy.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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