

### In a nutshell

**As a surplus of over 2 billion spare allowances continues to cripple the Emissions Trading Scheme (ETS), the EU institutions are debating a proposal to repair the scheme. This Market Stability Reserve (MSR) offers the chance to restore the carbon market as the EU's flagship climate policy.**

In this briefing Sandbag argues that Lithuania could reap advantages from supporting an enhanced Market Stability Reserve. We first argue why Lithuania should reconsider its position on the MSR. Then we present strong evidence based on ETS data, revealing the various ways in which the MSR would influence the competitiveness of Lithuania's industry in the EU economy. We finally provide more detailed information about how the proposed ETS reform would function if implemented.

### About Sandbag

Sandbag is a UK-based not-for-profit think tank conducting research and campaigning for environmentally effective climate policies.

Our research focus includes reform of the EU Emissions Trading Scheme, the EU 2020 and 2030 climate & energy packages, Carbon Capture & Storage/Utilisation, and the phase-out of old coal in Europe. The International Centre for Climate Governance ranks us in the top twenty global climate think tanks.

For more information visit our website at [www.sandbag.org.uk](http://www.sandbag.org.uk) or email us at [info@sandbag.org.uk](mailto:info@sandbag.org.uk)

### The Lithuanian Position

Sandbag welcomes Vilnius' support for the introduction of the MSR. It is also especially appreciative of Lithuania's willingness to prevent the supply shock that would befall the ETS if the 900 Mt of EUAs from the backloading decision were allowed to return onto the carbon market. Nevertheless, all this effort is still jeopardized by the fast pace at which the surplus continues to grow, and also by the additional supply-side shock posed by the unallocated allowances - the forcible auctioning in 2020 of EUAs that failed to be allocated during Phase 3. Therefore, **Sandbag would earnestly entreat the Lithuanian authorities to consider the evidence presented in this briefing, and to publicly call for the introduction of the MSR at a date significantly earlier than 2021, and for the unallocated EUAs to be placed into the reserve together with backloaded ones.**

Such an MSR reform would not only improve the functioning of the ETS, but would also allow Vilnius to ensure a greater value for the extra EUAs Lithuania stands to auction during Phase 4. These additional allowances could be used to boost investment in the low-carbon economy and to defray costs associated with a higher carbon price. **Countries where cumulative over-supply relative to cumulative emissions is at levels comparable to those in the Lithuania (66% over the 2008-2003 period), such as Latvia (79%) and Slovakia (53%), have realised this already and support an enhanced MSR.<sup>i</sup>** In exchange for its support for an enhanced MSR, Vilnius might conceivably consider requesting that the MSR in its operation do not affect groups of allowances to be auctioned that are relevant to Vilnius.

## The evidence supporting an enhanced MSR

There is strong evidence that Lithuania's government and industry can capitalise on the introduction of an enhanced MSR, as well as how Lithuania is well protected against any additional costs for years to come.

- Since 2008 Lithuania has amassed 24.4 million EUAs in excess of its emissions. **This makes the Lithuanian surplus the third highest cumulative over-allocation of all EU countries relative to cumulative emissions** - more than, with **66% more allowances than it needed**. Looking into industrial allocations alone (i.e. minus power installations), the degree of over-allocation is 39.3%<sup>ii</sup>.

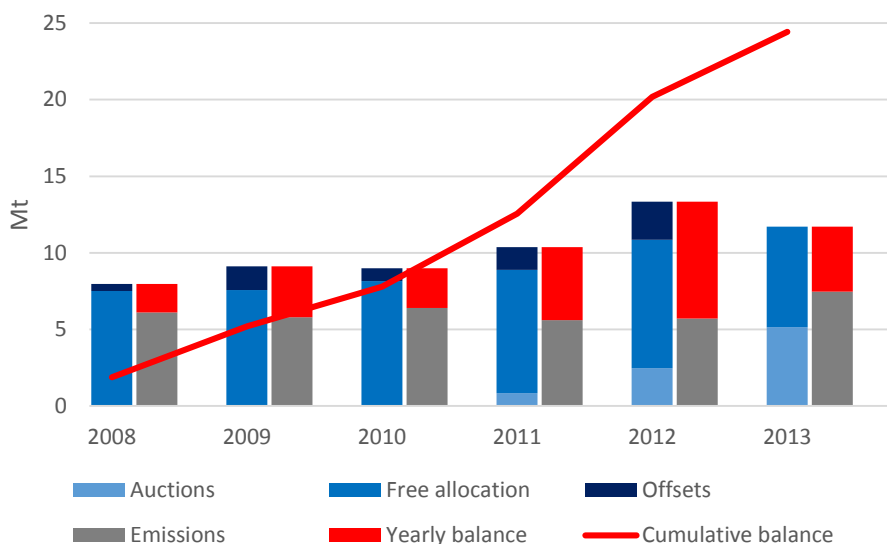


Figure 1: Cumulative balance of supply and demand under the ETS in Lithuania.

- **The Lithuanian auction revenues could rise by €80 million with the introduction of the enhanced MSR.** Estimates by PointCarbon<sup>iii</sup> show that, **with the MSR becoming operational in 2021 and the backload prevented from coming to market, Lithuanian revenues over the 2015-2025 period would be around €591 million.** A compromise position, **with an MSR starting in 2019 and placing the unallocated allowances into the reserve, would yield revenues of €672 million** over the same period. Therefore, auction revenues could rise by €80 million in the case of a more ambitious outcome, despite the contraction of auctioning volumes. These additional revenues could be used to offset costs incurred by actors with a heightened exposure to the carbon price.
- **The decarbonisation of the Lithuanian power sector could be the direct contributor to further abatement in Lithuania.** Under Article 10c of the ETS Directive, Lithuanian **electricity generators can receive until 2020 more than 2.9 million EUAs, worth today more than €20 million**, to help them defray the costs of modernising their electricity production. We estimate that **more than 6.5 million further EUAs will become available post-2020 for the same purpose – a massive expansion relative to the volume available in Phase 3.** As the decarbonisation of the power sector progresses, Lithuanian electricity consumers will become increasingly insulated from the carbon price.
- The three companies, one in each of the three largest Lithuanian industrial sectors, which account for over 97% of Lithuania's total industrial emissions will enjoy various kinds of protections under the enhanced MRS:
  - **AB "Achema" (44.7% of total industrial emissions) is competing fairly against other fertiliser producers.** Its cumulative balance at the end of 2012 stood at 0.99 Mt, making it 183% over-allocated. However, since 2013 it experienced for the first time a deficit because the scope of the EU ETS has changed, forcing the company to account for a very large volume of GHG emissions from its ammonia and nitric acid production as well. This change has affected all European fertiliser plants, and therefore, should not influence Achema's competitiveness, since **at least 85% of Achema's sales**

are realised within EU countries, where its competitors are exposed to the same climate regulations.

- **AB "OrlenLietuva"** (33.9%) **enjoys competitive advantage under the ETS.** Representing 100% of the Lithuanian mineral oil sector, its surplus is set to last until 2020. However, out of 23 EU ETS countries that have oil processing industry, 14 face a shortage situation before that date, giving Orlen a definite competitive advantage over its European peers if the European carbon price were to rise.
- **AB "Akmenės Cementas"** (17.9%) **is expected to be in surplus until 2023.** This is because, according to the company's own website, at the end of 2013 this cement & lime company has completed a modernisation project, which should lower CO<sub>2</sub> emissions by ~30%.
- The MSR does not act on freely allocated allowances, so **its introduction cannot take away this protection from Lithuanian industrial installations.**
- **The ETS includes generous provisions insuring that the ETS would not constitute an excessive burden on Lithuania's economy.** Concretely, even though in 2013 it accounted for only 0.39% of emissions under the ETS, Lithuania has received 2.1% of all additional allowances distributed to all Member States' auctioning pots for the purposes of solidarity and growth, as well as for recognition for the Member State's early action under the Kyoto Protocol. Therefore, far from placing an unfair burden on Lithuania's economy, the ETS has allowed **Vilnius authorities to benefit from the auctioning revenues of approximately 22.1 million additional allowances during 2013-2020, valued today at more than €155 million** that can be used to provide further shelter to Lithuanian consumers and companies.
- **These generous provisions will continue in the post-2020 period.** Lithuania will come to enjoy additional allowances for the purposes of solidarity, growth and interconnections. This will serve to protect the Lithuanian public and industry and help integrate Lithuania in European energy networks. Furthermore, Lithuania will also be able to finance the modernisation its energy systems through an enhanced fund, containing nearly twice as many allowances as the auctioning pot for early action holds in the 2013-2020 period. **An enhanced MSR can only bolster the value of these safeguards.**
- **An enhanced MSR could therefore boost Lithuania's revenues through better auction receipts.** To provide better protection to politically sensitive stakeholders, Lithuania could request the following be shielded from the MSR: the post-2020 allowances for solidarity, growth and interconnections; the allowances available under Article 10c; and the allowances funding the modernisation fund. Instead, countries not in receipt of solidarity measures could place proportionately more allowances into the reserve.

## Sandbag's recommendations for the Market Stability Reserve proposal

The inability of the European carbon market to correct supply and demand imbalances is a fundamental design flaw, and creating an automatic mechanism to do this, both in situations of shortage and of over-supply, would create a more stable and predictable environment for businesses to thrive and Europe to decarbonise. The proposed measure, a Market Stability Reserve (MSR), would introduce a transparent, predictable and non-discretionary mechanism to reduce the huge and growing over-supply. By automatically adjusting supply by altering on EUA auction volumes, imbalances could be avoided in the future – both during oversupply and shortage situations.

Unfortunately, even using the Commission's own conservative surplus forecast, their original MSR proposal allows the surplus to rise up to 2.2 billion tonnes by 2020. Moreover, the surplus will not increase gently, but is instead expected to develop chaotically due to a series of massive supply-side shocks that are set to occur over the next five years, as is shown in red in Figure 2. When the market experience such constant ups-and-downs, companies under the ETS have no reliable policy framework guiding their investment decisions consistently towards decarbonisation, which is why this "rollercoaster effect" must be avoided at all costs.

In order for correct for this rollercoaster, Sandbag recommends the following three proposals for enhancing the Commission's Market Stability Reserve proposal, based on analysis of the ETS data:

- 1. Launch the MSR without delay in 2016;**
- 2. Prevent the backloaded allowances from returning to the market;**
- 3. Prevent the unallocated allowances from returning to the market.**

### The coming allowance supply shocks

The first supply-side shock is due to the "backloading" decision, which postponed the auctioning of 900 million EUAs that were slated for auctioning at the beginning of Phase 3 (2013-2020) until the last two years of the same phase. That decision was taken in 2013 in order to postpone the crash that the glut of EUAs would have otherwise caused at the beginning of the phase. Obviously, postponing the auction only postpones this crash, which is why the Council, Parliament and Commission are currently discussing the placement of these 900 million EUAs directly into the reserve as a permanent solution for this problem.

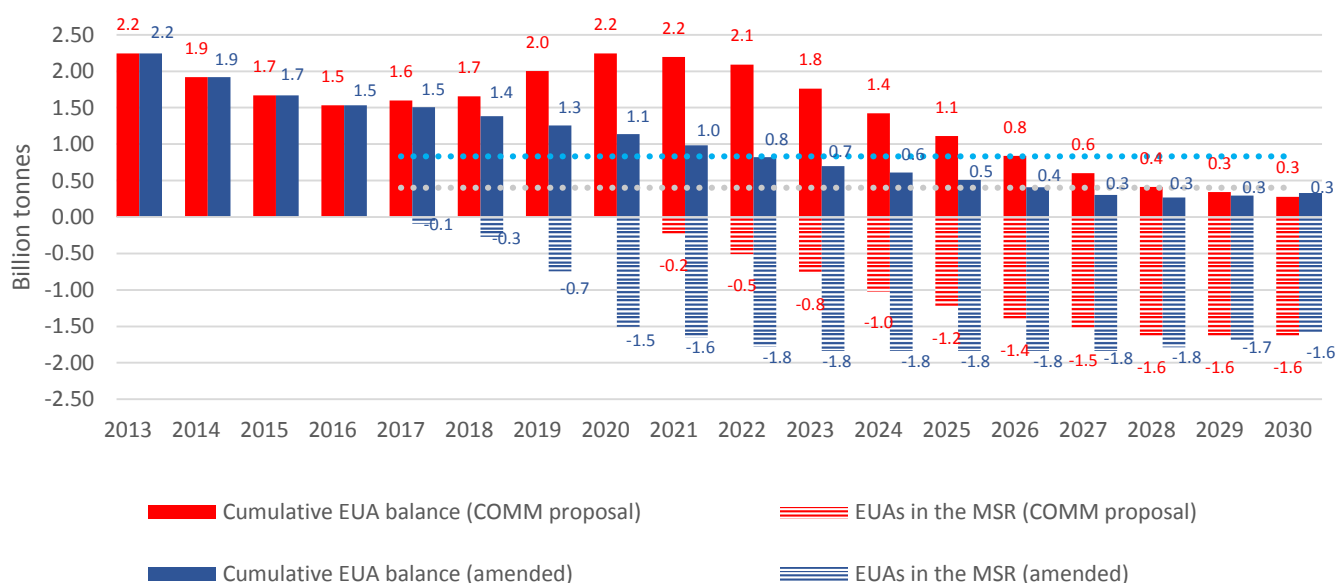


Figure 2: The carbon market effect of an early start and placing the backload into the MSR

The second supply-side shock is due to the simultaneous release by means of auctioning of a large volume of allowances that had originally been meant for free allocation, but, for one of two possible reasons, were not actually allocated during Phase 3. The first possible source of unallocated allowances is the New Entrants' Reserve, which contains a large volume of EUAs meant for allocation to installations that were not previously covered by the ETS (e.g. newly established companies, new production lines, newly regulated production processes, etc.). The second source of unallocated allowances is made up of EUAs withheld from installations whose production has fallen by 50% or more. According to the ETS Directive, allowances for both sources must be auctioned in the last year of the phase, i.e. 2020. [Sandbag estimates that the total volume of unallocated allowances would be 754 Mt.](#)<sup>iv</sup> The sudden release of these EUAs must be avoided, as well, since it would have the same destabilising effect on the market as the release of the backloaded EUAs would.

Finally, Sandbag, akin to the government of the United Kingdom, has reservations about the accuracy of the Commission's emissions forecast. The surplus expected by the Commission in 2020, of around 2.6 billion tonnes without an MSR, is strongly influenced by expectations for electricity consumption over the next five years. Contrary to the Commission, which expects electricity consumption to rise, Sandbag believes that the falling trend in electricity consumption will continue, giving rise to [a 4.4 billion tonne surplus by 2020.](#)<sup>v</sup> (The British government forecasts a surplus of nearly 3.1 billion tonnes for the same year.) In order to restrain the unbridled rise of this surplus, and thereby restore the credibility of the ETS as an effective instrument of European climate policy, the MSR must start much earlier.

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## Footnotes

<sup>i</sup> Latvia, due to holding the Council Presidency during the first half of 2015, does not currently have an official position. However, prior to taking on this role, Riga had spoken out in favour of an early start (2017).

<sup>ii</sup> Adjusted for AB "Achema" reclassification as chemical plant due to the scope change of the EU ETS in 2013. Achema claims that due to this scope change it was reclassified as a chemical plant (previously combustion installation) in Phase3. The latest EUTL data still lists the company under combustion plants, but for transparency reasons Sandbag places Achema under chemical sector.

<sup>iii</sup> This value is based on an update requested by Sandbag to PointCarbon's projections from February 27, 2015, which had contrasted the expected impact of an MSR designed according to the outcome of the ENVI vote against the expected impact of the MSR as proposed by the Commission. The difference between the revenue impact of the ENVI MSR and that of the Commission MSR was estimated at 1.5 billion tonnes. A large part of this has already been secured by the Czech Republic when it agreed to transfer the backloaded allowances into the reserve.

<sup>iv</sup> [Avoiding the Avalanche](#), February 2015

<sup>v</sup> [The Eternal Surplus of the Spineless Market](#), March 2015.

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