ALLOWANCE RESERVES ACROSS EMISSION TRADING SYSTEMS

This briefing note describes how the concept of an allowance reserve mechanism has been designed in different emission trading schemes around the world. It takes into consideration systems in Europe, RGGI, California, and Quebec. The intent is to provide a brief description of such reserves and facilitate the comparison of their design.

EU ETS – Market Stability Reserve

The European Commission's proposed framework for climate and energy policies for the 2020-2030 period includes a proposal to reform the EU ETS by establishing a Market Stability Reserve (MSR). This reserve has two-stated objectives and a third, implied objective. It aims to address the surplus of allowances that has built up in recent years and to improve the system's resilience to major demand shocks by automatically adjusting the quantity of allowances to be auctioned. It also has the potential to address the problem of uncoordinated policies at the European level.

Technical details:
The proposal by the Commission foresees the MSR starting in 2021, at the start of Phase 4 of the EU ETS. The parameters to feed allowances into the reserve or to release them to the market through auctioning, is built on **volume-based triggers**.

- The proposed threshold, above which EU allowances would enter into the reserve, is set at **833 million tonnes** of allowances in circulation in the market. In this case **12%** of the EUAs in circulation in year y-2 would be deducted from future auctioning volumes and put in the reserve.
- The proposed threshold for releasing EU allowances from the reserve would occur when there are **400 million tonnes** of allowances or less in circulation in the market. In this case a **fixed annual amount of 100 mln** EU allowances would be released into the market through auctioning, from the reserve (this represents approx. 5% of current annual EU ETS emissions).

Note:
The MSR is designed to work across trading periods. The Commission's proposal includes also a specific measure to smoothen auction volumes and avoid supply-demand imbalances at the end of trading periods.

Objective of the reserve:
The reserve is being considered to address the surplus of emission allowances and improve the system's resilience to major shocks in demand-supply imbalance by automatically adjusting the supply of allowances to be auctioned. This would occur automatically, according to clear and well-established rules that leave no discretion for its implementation.

Next steps:
The Commission's proposal is now going through the normal legislative process of co-decision, which means that European Member States and European politicians will assess the proposal, possibly amend it, and will need to negotiate an agreement before this is implemented into legislation. Clarity on the final agreement on the MSR may not happen before 2016 or 2017.
The reserve would constitute a permanent design change of the EU ETS. A review on the level of the parameters of the MSR is foreseen (rather than a review on the reserve as such) and is expected to take place by 2026.

RGGI Cost Containment Reserve (CCR)

The Regional Greenhouse Gas Initiative (RGGI), a cap-and-trade system in place for the power sector in nine U.S states, recently established a Cost Containment Reserve (CCR) to be used when auction prices for allowances exceed a certain level. The table below provides information on the size of the CCR and trigger price.

RGGI's Cost Containment Reserve (CCR)		
Year	**Reserve Amount**	**Trigger Allowance Price**
2014	5MT	$4/tonne
2015	10MT	$6/tonne
2016	10MT	$8/tonne
2017	10MT	$10/tonne
2018	10MT	+2.5% from 2017

The vast majority of allowances in RGGI are auctioned, not freely allocated. The CCR makes available these reserve allowances immediately when auction prices reach the trigger price. The CCR allowances are only sold at or above the CCR trigger price. If allowances are withdrawn from the CCR it is automatically replenished in the following year.
The CCR came into effect in 2014. It coincided with a number of other policy changes, most significantly a reduction of the cap by 44.8% between 2013 and 2014. The first auction triggered the release of the 5MT CCR, due to high demand for allowances, and all 5MT allowances were purchased in that auction.

Objective of the reserve:
The Cost Containment Reserve is meant to contain costs and prevent prices from going too high.

Next steps:
After 2018 the rules will be revised and each RGGI State will need to renew the legislation. The presumption is that the CCR will remain part of the RGGI regulations after 2018.

California's Allowance Price Containment Reserve

The California greenhouse gas cap-and-trade programme features a cost containment mechanism known as the Allowance Price Containment Reserve (APCR), intended to act as a safety valve in the event that allowance prices rise too high for the market and for the economy. The APCR offers a pool of allowances for sale four times a year, six weeks after each quarterly auctions.

Details of the APCR:

The APCR is comprised of allowances that are withheld from California's allowance auction budget each year. This means the APCR allowances fall within California's overall allowance cap. The number of allowances withheld each year to fill the APCR are as follows:

Compliance period	% of allowances withheld	Budget Year	Annual Allowance Budget	MM of allowances withheld
1st	1%	2013	162.8	1.628
		2014	159.7	1.597
2nd	4%	2015	394.5	15.78
		2016	382.4	15.296
		2017	370.4	14.816
3rd	7%	2018	358.3	25.081
		2019	346.3	24.241
		2020	334.2	23.394

Sources § 95841 p104 - § 95870 p142 California Air Resources Board MODIFIED REGULATON ORDER Sub-ch.10 Ar.t 5 and IETA calculations

Eligibility:

Only compliance entities (i.e. companies with compliance obligations under the California cap-and-trade regulation) are eligible to purchase APCR allowances. Allowances purchased from the APCR must be used for compliance purposes only, and may not be traded on the market. Despite the link with the Quebec ETS, only California-registered entities may purchase from the California APCR (Quebec has its own, separate reserve for Quebec entities).

APCR Price Levels:

The price levels that the California Air Resources Board (ARB) will sell APCR allowances to compliance entities is set at a pre-determined level. Allowances within the APCR are divided into three equal tiers, and each tier is offered for sale at a different price level – this price level increases by 5% (plus inflation) annually. In 2014, APCR prices are as follows:

- Tier 1: $42.38
- Tier 2: $47.68
- Tier 3: $52.98

To date, secondary market prices for California allowances have remained below the APCR tier prices, and so far no entities have participated in APCR sales.

Possible changes to the APCR:

There have been concerns from Californian stakeholders that if allowance prices on the secondary market rise too high, the APCR will be insufficient in adequately containing costs. While the APCR has the ability to provide some temporary relief of higher-than-desirable allowance prices, the reserve is not unlimited, and could be exhausted relatively quickly.

While these concerns are preliminary at this point (as allowance prices remain well below APCR price tiers), California ARB is taking steps to improve the APCR's ability to contain costs. In the proposed amendments, scheduled to be finalised in April 2014, if APCR allowances were to be exhausted, additional allowances would be made available. The proposal would offer a temporary solution by taking 10% of future years' allowance budgets (starting with the 2020 budget year) and offering those allowances for sale once per year at the highest price tier of the APCR (beginning in 2015). With this proposal, future allowances would be borrowed to satisfy short-term supply shortages. The proposal does not address longer-term structural supply shortages.

Quebec Allowance Price Containment Reserve

The rules of the reserve sales are very similar to California's process. An allowance reserve account is held by Quebec's Minister of Sustainable Development and Environment, in an effort to ensure cost containment. This account holds:

- 1% of allowances under the cap for 2013 and 2014
- 4% of allowances under the cap set for 2015 to 2017
- 7% of allowances under the cap set for 2018 to 2020
- 4% of allowances under the cap set for 2021 & beyond

This allowance reserve is used as a soft price ceiling; if allowance prices rise to a pre-determined level, these reserve allowances will be made available via a "sale by mutual agreement", which would be coordinated by the Western Climate Initiative (WCI Inc.). Alternatively, the Minister may choose to use these reserve allowances to adjust the amount of free allowances allocated to emitters. In the case of a sale by mutual agreement, allowances in the reserve would be equally divided into three categories to be sold at the following prices:

- Category A: CAD $40 per emission unit;
- Category B: CAD $45 per emission unit;
- Category C: CAD $50 per emission unit.

These prices were set in 2013 and will increase annually by 5% plus inflation until 2020.

Contrary to California, there is no predetermined date in Quebec's Regulation for holding sales by mutual agreement. A maximum of four such sales may be scheduled annually, but the decision to hold them or not belongs to the Minister.

The allowances purchased from the reserve must be used for the entity's regulatory compliance as they will be directly transferred to the entity's compliance account; it will therefore not be possible to resell those allowances on the market. The administration of the reserve has been delegated to the WCI, which manages the process and the sale settlement process.

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