



Why the MSR2 non-paper should be a non-starter

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Introduction

On 25 June 2025, 16 EU member ¹ states released a non-paper to request that the European Commission assess various options for a reform of ETS2, the new emissions trading system for buildings and road transport beginning in 2027.

The involved member states are concerned about the risk of high or volatile ETS2 prices and also express uncertainty about the initial price level. While the risk of high prices can be managed without reform of the ETS2, the proposed revisions include proposals that would weaken the ETS2 and lower climate ambition through reform of the market stability reserve (MSR2).

What is the Market Stability Reserve (MSR2)?

The MSR2 operates by adjusting the supply of emission allowances (EUA) to regulate the ETS2 in response to changing market conditions.

A MSR was introduced to the EU ETS1 in 2018 as a stabilising, price control mechanism to fix a saturation problem that occurred when an overabundance of EUA caused the carbon price to drop to as low as €5 for one tonne of carbon.

How does the MSR2 work?

When there is an excess supply of allowances, the MSR absorbs some from the market, reducing oversupply and keeping prices higher than they otherwise would be. If allowances are undersupplied in the market, the MSR releases additional EUAs into the market, which lowers prices to below what they otherwise would be.

The MSR2 includes both volume and price based triggers.

Volume-based triggers:

- If the Total Number of Allowances in Circulation (TNAC – which is the excess supply of allowances in the market) exceeds 440 million tonnes of CO₂, 100 million allowances are removed from the market over a period of 12 months.
- If the TNAC falls below 210 million tonnes of CO₂, 100 million allowances will be released from the MSR into the market.
 - If the volume of allowances in the MSR falls below 100 million tonnes of CO₂, all of the allowances in the MSR enter the market.

Mechanisms based on price triggers or 'price controls':

- If the average price during three consecutive months is more than double the average of the previous six months, 50 million allowances will enter the market.
- If the average price during three consecutive months is more than three times the average of the previous six months, 150 million allowances will enter the market.
- From 2027–2030 a 'soft price cap' is in place at €45 (inflation adjusted) which is maintained by releasing 20 million allowances when this price is triggered.

Allowance releases based on these trigger mechanisms can only start to operate in 2028 and are limited to two (normally one) per year, explaining why expected total releases in the period until end of 2030 are below the total size of the MSR2².

¹ Austria, Belgium, Bulgaria, Croatia, Czechia, Estonia, Germany, Italy, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Spain

² See section 2.5 and table 5 of the recent report for the German Environment Agency by Graichen and Ludig (2024). They analyse the amount of MSR allowances used and find that under different assumptions about price evolution, only a very limited amount of MSR allowances are used. Under the current rules, they estimate that 467–600 million allowances are invalidated in 2031 as the MSR2 ends.

Price control mechanisms in action

These price controls are in place until 2029 when the European Commission is required to report on their functioning, after which the European Commission could propose to extend and expand price controls if needed. Finally, an additional clause also allows the European Commission to respond to high ETS2 prices by issuing an implementing act which allows the MSR-triggers to release allowances every 6 months.

Alongside the frontloading³ of allowances, these MSR interventions influence the volume of emission allowances auctioned in any given year.

The MSR2 is endowed with 600 million certificates which allow for additional emissions on top of the ETS2 cap on emissions. The additional emissions, if all the MSR's certificates enter the market, correspond to around 5-10% of total ETS2 emissions. However, forecasts project that not all of the MSR2 volume will be used. Rather, projections imply only a rather small part of the MSR2 volume will translate into additional emissions under current rules⁴. Relaxing the rules governing the release of allowances from the MSR would lead to higher emissions under the ETS2 system.

Furthermore, any changes to these rules should be carefully considered to avoid reducing the effectiveness of the investment signal and undermining market participants' confidence in a stable and reliable regulatory framework.

This brief explainer outlines the rationale for the five different measures discussed by the non-paper, and also highlights the risks such changes will create in terms of generating higher emissions and the dangers politically of opening up different legislative instruments. The three main legislative instruments which could be reopened to make the below changes to the ETS2 are the [Market Stability Reserve decision](#) which establishes an MSR in ETS1 and 'MSR2' in ETS2, the [ETS directive](#), the basis of ETS1 and ETS2 and the [auctioning regulation](#) which sets out the rules for the buying and selling of EUAs.

³ In the first three years, 30% more emissions will be auctioned than is typically allocated to this year, with corresponding reductions in the number of allowances auctioned in the following years 2029–2031.

⁴ As noted in footnote 2, the recent [report](#) for the German Environment Agency by Graichen and Ludig (2024) finds that only a very limited amount of MSR allowances are likely to be released. Under the current rules, they estimate that 467–600 million allowances are invalidated in 2031 as the MSR2 ends.

Changes without reopening legislation

1. Regularly publish information to better inform price forecasts for ETS2

As the ETS2 is a new market there is not a clear picture of what the ETS2 price will be, with limited activity in the [ETS2 futures market to date](#). The price is dependent on the level of carbon emissions from buildings and road transport. Therefore, the publication of official, regular and updated information on expected emissions for ETS2 sectors, rates of heat pump installation, electric vehicle uptake and renovation rates is a helpful suggestion to ensure market actors have a better understanding of the ETS2 price in the medium term. Greater certainty of the price level encourages consumers, companies and governments to invest in decarbonisation earlier and would result in the ETS2 price being lower for all.

Implementation of this measure: This measure could be adopted by the European Commission without any legislative changes, ideally in close collaboration with national statistical agencies, Eurostat and other relevant information providers.

Climate effect: This measure would have no influence on altering the cap of the ETS2 or the maximum number of allowances in the Market Stability Reserve. More information for market actors on future prices helps to create more certainty for investment and helps to achieve faster decarbonisation, lowering emissions and ultimately leading to fewer allowances released from the MSR2.

Reopening the Auctioning Regulation

2. Launch early auctions in 2026 to reduce price uncertainty for 2027

The non-paper requests an assessment on the feasibility of beginning ETS2 auctions from mid-2026 so that households, businesses, fuel suppliers and ministries have a clearer forecast of the ETS2 price prior to 2027. Earlier auctions would not require additional emission allowances to be added to the market as it rather redistributes the 2027 auction calendar over 1.5 years rather than 12 months.

Implementation of this measure: Bringing forward the date of the start of auctions would require a reopening of the [auctioning regulation](#). As there are limited elements within this regulation, reopening it can be a practical, positive step with low political risk.

Climate effect: This measure would not change the cap of the ETS2 or the maximum number of allowances in the Market Stability Reserve. If this measure helps reducing demand for emissions, the release of allowances from the MSR2 could be reduced and thereby the amount of emissions from ETS2 could fall.

The importance of emissions reductions as an ETS2 price control measure

Carbon prices under ETS2 will rise if emissions are not reduced fast enough. Any 'complementary' measures that reduce emissions in ETS2 sectors help to contain the ETS2 price⁵.

⁵ See the [study](#) by Günther et al. (2025)

When considering possible solutions to concerns about the ETS2 price the most important consideration from an environmental perspective is whether the change will result in the total cap on emissions increasing. All MSR2 allowances (600 million), are in addition to the emissions cap of just over 1 billion allowances for 2027, and will approximate around 10% of the total emissions allowances from 2027-2032.⁶

Without the planned 42% emissions reductions in ETS2 sectors by 2030 relative to 2005 levels – it will be much harder to reach the EU's climate targets. Any increase in the level of emissions from ETS2 sectors requires a decrease in the level of available emissions from other sectors such as agriculture – which remains politically difficult, or land use sectors where the effectiveness of carbon sinks is already at risk.

Reopening the MSR Decision

The next three proposals in the non-paper seek to weaken the ETS2 by adding more emission allowances to the market through a reopening of the Market Stability Reserve Decision, the legal text defining the functioning of the MSR2. These changes would directly increase the allowable greenhouse gas pollution from buildings and road transport in the EU.

3. 'Smooth' the MSR trigger mechanism to limit volatility, as in ETS1, and increase the released MSR volumes in tight market conditions

This section includes two different measures:

First, the non-paper requests to review the triggers of MSR2 allowance release. The 'trigger mechanism' refers to the fact that the MSR2 is set up in such a way that once the level of allowances in the market is lower than 210 million, 100 million allowances will be added to the market. Similarly, the trigger is activated should the number of allowances in the market reach more than 440 million, at which point 100 million allowances will be removed from the market.

'Smoothing the trigger mechanism' means that rather than the whole amount of allocated allowances entering or leaving the market once the trigger point is met, a proportion of the allocated allowances relative to the surplus or lack, enters or leaves the market. The effect of this is that any potential shock to market participants due to a large number of allowances entering or leaving the market is limited. The aim is to reduce price fluctuations by lessening uncertainty over the supply of allowances.

Second, the non-paper requests that the Commission "explore the possibility to slightly increase the volume of allowances released in instances of a very tight market". The language here is vague. It is unclear what will constitute a 'tight market condition', and it is equally uncertain how substantial the "increase" would be. While this measure can lead to reduced allowance prices in the short term, it also reduces the incentive to lower emissions, meaning that more costly emissions reductions need to be achieved at a faster rate later.

⁶ See tables 3 and 5 of Umweltbundesamt 2024 (Supply and Demand in the ETS2), noting that the 600 million allowances of the MSR come on top of supply provided there, and that precise figures will depend also on emissions data from 2024–2026.

Climate effect of trigger reform: Changes in the trigger rule could be designed to reduce the likelihood of total emissions increasing (more triggerpoints but smaller allowance releases). More likely, however, is that reform of the triggers will lead to increased emissions from MSR2 and therefore from the ETS2 system, as under current rules only a limited amount of emissions from the MSR2 are foreseen (see footnote 3).

Climate effect of larger releases: Increasing the amount of MSR2 allowances released into the market in tight market conditions may well increase overall emissions under ETS2, as under current rules only a limited amount of emissions from the MSR2 are foreseen (see footnote 3).

Implementation of these two measures: These measures require reopening the MSR decision, a legislative act of the European Parliament and the Council. This includes the risk that co-legislators may use the opportunity to propose further elements that weaken the ETS2 (see below), including altering rules in such a way that without opening the ETS Directive all allowances in the MSR could be released to the market, raising the supply of emissions by around 10%.

4. Extend the MSR lifetime beyond 2031

Considering that all allowances in the MSR2 are in addition to the emissions cap, a rule exists that all allowances remaining in the MSR2 will be deleted in 2031 as a safeguard against potential issues of allowance oversupply should emissions be reduced at higher levels than expected. The non-paper suggests ending this “sunset clause”, thereby lengthening the period during which allowances can be introduced to the ETS2 market from the MSR2.

Implementation of the measure: This measure requires reopening the MSR decision, a legislative act of the European Parliament and the Council. This includes the risk that co-legislators may propose other elements that weaken the ETS2 (see below) beyond the proposed lifetime extension.

Climate effect: Extending the MSR2 lifetime beyond 2031 will increase overall emissions under ETS2 unless the total amount of allowances from the MSR2 are already used by 2031. As already noted, projections (see footnote 3 above) suggest only a small fraction will be used. Thus extending the lifetime will lead to more allowances and more emissions. To limit the amount of additional allowances transferred to the market, the non-paper suggests a cap on the volume of new allowances that can be released during this new extension period (after 2031).

5. Reinforce the price control mechanisms

The non-paper asks that the initial ‘soft price cap’ of 45 €/2020/tCO₂ is strengthened, by increasing either the volume of allowances released or the frequency of injections from the MSR2 into the ETS2 market. Both options would lead to an increase of carbon emissions.

Climate effect: The reforms suggested here amount to reforming the trigger mechanism and the volumes released, and must be considered in terms of their real emissions impacts. Under current rules only a limited amount of emissions from the MSR2 are foreseen (see discussion of option 3 above and footnote 3).

Implementation of the measure: This measure requires reopening the MSR decision, a legislative act of the European Parliament and the Council. This includes the risk that co-legislators may propose other elements that weaken the ETS2 beyond a reform of the trigger mechanism.

To move beyond a “soft price cap” to anything like a “hard price cap” requires giving up on the existing hard cap on emissions under ETS2. With demand for emissions uncertain, a hard cap on both emissions and the price is impossible. Changing the cap on emissions under ETS2 would require reforming the ETS directive.

A key argument against designating price ceilings or corridors relates to the legal risk that the ETS2 might then be deemed a tax and subject to unanimity rather than qualified majority in the Council.

Conclusion

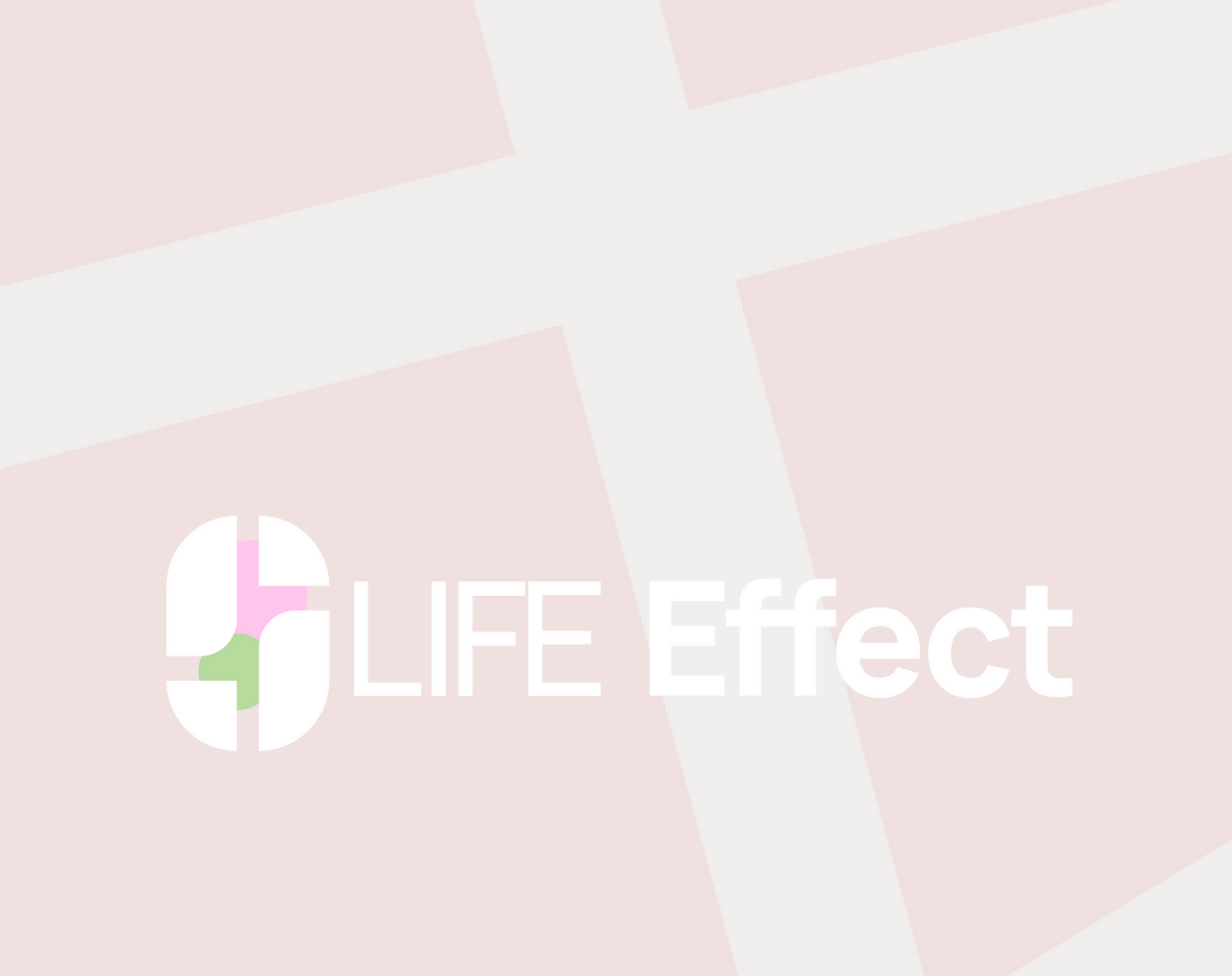
The most sensible approach is not to intervene in the market before the performance of the current set-up has been proven to be deficient particularly when the price is unknown and certainty is essential to maintaining the investment signal. A review of the system is foreseen in 2028 already.

The challenges in terms of high prices require resolute actions by EU member states and the European Union to reduce emissions rather than introducing additional allowances. Any policy measures that reduce emissions in the ETS2 sectors reduce the ETS2 price: sensible measures include regulatory policies limiting the sale of new fossil technologies such as internal combustion engine cars and gas boilers for heating water and buildings, mandating lower temperatures in buildings and lower speed limits on highways, promoting teleworking to prevent commuting etc. In addition, carbon floor prices set at a national level can be used to complement the ETS2 price signal particularly if implemented in member states with an already existing carbon price of comparable value to the future ETS2 price or with a large share of emissions. Governments can and should reduce the impact of high prices especially on vulnerable households. Appropriate distribution of ETS2 revenues can reduce inequalities as well as help finance the energy transition. Essential regulatory policies can also serve climate-social objectives, in particular regulations that effectively incite landlords to insulate buildings and renovate heating systems. Frontloading a part of the ETS2 revenues can allow countries to invest in the transition earlier.

The consequences for emissions could also be great, for example in times of uncertain gross fossil fuel prices – very low wholesale prices combined with a cap on ETS2 prices could lead to high levels of emissions.

While the reforms proposed by the non-paper may appear limited, they would result in increasing the amount of allowances that enter the market from the MSR2. This should not be taken lightly as each tonne of CO₂ in the MSR2 is already in addition to the cap on allowances for ETS2 sectors of just over 1 billion tonnes of CO₂. Every additional tonne added to the market means exceeding the emissions reduction target and additional emissions reductions must make up the difference in other sectors if countries hope to meet their national emissions reductions targets and avoid costly fines under the Effort Sharing Regulation.

It is essential to ensure that the integrity of the ETS2 is protected, otherwise the credibility of the whole EU climate policy framework is in doubt. Political commitment is essential to ensure clean investment decisions are made now and limit the cost of the transition. EU member states have the tools needed to limit the impact of the ETS2 on citizens through strong additional policies to lower emissions and investment and targeted income support.



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