WHAT IF THE EU ETS WAS WELL-FUNCTIONING?

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Overview

The EU ETS is one of the centerpieces for the European emissions reduction objectives and represents an ambitious attempt to create a genuine market for CO2. Until now, Europe seems to be on track for achieving its emission target of minus 20%. Yet since several months many observers have been complaining about the functioning of the EU ETS and claimed for regulatory intervention. What do these critics claim is wrong with the EU ETS? Is there really anything wrong? Can its shortcoming be remedied by some intervention, or is the whole approach fundamentally flawed?

The EU ETS has been under constant scrutiny by the European commission, European industry and the media since its launch in 2005. The criticisms concern mainly the level of CO2 prices today that are (almost) unanimously considered as "too low". This paper discusses whether CO2 prices are effectively too low and if the different proposals on the table would address the issue.

Methods

This paper offers a systematic review of the current discussion around the review of the EU ETS. This paper argues that the statement "CO2 price are too low" is a perception with limited economic foundation. Secondly it discusses the different proposals (e.g. set aside) of intervention which, regardless of their impact, would create a precedent. Third the paper addresses the key issue which is not with the EU ETS but rather with (1) the global economic crisis and (2) the lack of consistency of the EU policy. Finally different possible scenarios for the future of the EU ETS are described.

Results

This paper explains that EU ETS is functioning in accordance with the way it has been designed. CO2 prices are not too low, they simply reflect the fact that there is limited need for abatement, and mainly represent an option value post 2020. Current price levels do not justify new investment, but there is simply no need for investment in the short-term. An important difficulty is the existence of parallel mechanisms that create implicit CO2 prices. Low CO2 prices are a collateral damage of overlapping EU policies. Over the long term the EU has to decide whether it wants to rely more on implicit or explicit CO2 prices and which space is left for market mechanisms.

Conclusion

In conclusion CO2 prices today are the result of two main factors: bad luck and market design. Bad luck due to the economic crisis that was not anticipated at the start of the EU ETS and led to an "easy target". Arguably policy makers can be forgiven for that. Market design is linked to the overlapping targets and policy tools. The EU ETS creates an explicit price of CO2. What matters for the EU as a whole is the implicit price of CO2. The EU ETS being the only market driven tool it adapts to the development driven by the other tools. Any intervention, as suggested by many observers, would arguably create a precedent and reduce the long-term credibility of the EU ETS.

[1] The statements, opinions, and ideas expressed within this paper are the sole responsibility of the author. GDF SUEZ is not responsible in any way, manner or form for these statements, opinions, and ideas.

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